# OVERVIEW OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1988

## HEARINGS

BEFORE THE

## COMMITTEE ON WAYS AND MEANS
## HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

FIRST SESSION

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# OVERVIEW OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1988

TUESDAY, FEBRUARY 3, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, DC.*

The committee met, pursuant to call, at 11:15 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[Press release No. 6 of Tuesday, January 27, 1987]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES HEARINGS TO OBTAIN AN OVERVIEW OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1988

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced four days of public hearings to obtain an overview of the President's Budget for Fiscal Year 1988. The hearings will be held on Tuesday, February 3, and Wednesday, February 4, beginning at 10:00 a.m.; on Wednesday, February 11, beginning at 9:30 a.m.; and on Wednesday, February 25, 1987, beginning at 10:00 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building, each day.

Testimony will be received from Administration officials and invited witnesses only. The leadoff witness on February 3 will be the Honorable James C. Miller III, Director of the Office of Management and Budget, to be followed at 2:00 p.m. by representatives of the Department of the Treasury and the Department of Labor. On February 4, the Committee will hear from Dr. Rudolph G. Penner, Director of the Congressional Budget Office. On February 11, testimony will be received from invited expert witnesses.

On Wednesday, February 25, the Committee will hear from the Honorable Otis R. Bowen, Secretary of the Department of Health and Human Services (HHS). Secretary Bowen will testify on HHS budget issues and welfare reform.

Additional hearings will be scheduled on specific budget proposals at which public witnesses will be given the opportunity to testify. These hearings will be announced in subsequent press releases.

In announcing these hearings, Chairman Rostenkowski said, "We must reduce the Federal budget deficit. There should be no higher priority for the 100th Congress. The questions are how, and how fast, do we cut the deficit. As we begin the budget process, it is important for the Committee to understand how the Nation's economy is performing and the economic impact of the different ways of reducing the deficit. Also, we need to consider the economic implications of achieving the Gramm-Rudman deficit targets for Fiscal Year 1988 and beyond. The Committee will begin by looking at the Fiscal Year 1988 budget and deficit reduction measures proposed by the President."

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Any interested person or organization may file a written statement for inclusion in the printed record. Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies by the close of business, Friday, February 27, 1987, to Joseph K. Dowley, Chief Counsel, Committee on Ways and

Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

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[Press release No. 7 of Wednesday, February 11, 1987]

HON. DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES DETAILS FOR THE HEARING ON HEALTH AND HUMAN SERVICES AND WELFARE REFORM PROPOSALS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1988 BUDGET

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced additional details and a change in time for the hearing on the President's Fiscal Year 1988 Budget for the Department of Health and Human Services and the welfare reform proposals contained in the President's Budget. (See also Press Release #6, dated January 27, 1987.) The hearing will be held on Wednesday, February 25, 1987, beginning at 9:30 a.m., in the Committee's main hearing room, 1100 Longworth House Office Building.

The Honorable Otis R. Bowen, M.D., Secretary of the Department of Health and Human Services (HHS), will be the sole witness at this hearing. It is anticipated that additional hearings will be scheduled by appropriate subcommittees of the Committee on Ways and Means on specific budget proposals at which public witnesses will be given the opportunity to testify.

In announcing the hearing, Chairman Rostenkowski said, "The President's Fiscal Year 1988 Budget recommendations include changes in the medicare, social security, Aid to Families With Dependent Children, and child support enforcement programs. His welfare reform proposals will also impact on several programs under the Committee's jurisdiction. It is important for the entire Committee membership to get an overview of the HHS budget recommendations and the Administration's welfare reform proposals. Such an overview will be very useful in preparing both for subcommittee and full Committee action on these proposals."

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE

Any interested person or organization may file a written statement for inclusion in the printed record of the hearing. Persons submitting written statements for the printed record should submit at least six (6) copies by the close of business, Friday, March 6, 1987, to Joseph K. Dowley, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515.

Chairman ROSTENKOWSKI. The committee will come to order.

Today we begin a series of hearings on the President's budget for fiscal year 1988, and the impact of the deficit on the economy.

Our first witness is the Honorable James C. Miller III, Director of the Office of Management and Budget.

Dr. Miller, there isn't a committee in the Congress that has taken more tough votes on the deficit reduction than the Committee on Ways and Means. I am sure that this year will be no exception. Very quickly, we are going to find ourselves in the middle of the fiscal year 1988 deficit reduction debate. At the same time, we will be working on trade reform, catastrophic health insurance, and welfare reform.

No committee is more aware of what can be accomplished when the President and the Congress work together. We faced the tough decisions on tax reform with the President; and, together, we were able to do what many people said was impossible.

Having seen first-hand what the President can do when he provides the necessary leadership, I must say I am very disappointed in the President's fiscal year 1988 budget. I do not think it represents feasible priorities. By your own admission, it violates the

Gramm-Rudman-Hollings Act for fiscal year 1989 and beyond for the deficit targets are not achieved.

A preliminary analysis by the Congressional Budget Office indicates that the President's budget misses the deficit target for fiscal year 1988 by $27 to $32 billion. Two-thirds of the President's recommendations falling within this committee's jurisdiction have either been considered and rejected by the committee in recent years, are only one-time savings, or break bipartisan agreements reached last year.

As we begin the budget process, it is also important for the committee to know how the Nation's economy is performing. We need to understand the economic consequences of the President's budget as well as other ways of achieving the Gramm-Rudman fiscal year 1988 deficit target of $108 billion. The committee has a history of success in working with the President when he is actively and positively committed to a legislative goal.

The most important questions for you, Dr. Miller, are: Is the President serious about the budget? Is he prepared to work with Congress to achieve the necessary deficit reduction? I am sure that you will be able to answer that in your testimony, Dr. Miller.

In the meantime, I recognize my colleague, Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I would like to welcome you to the committee, Dr. Miller. We are always pleased to have you, and especially today, to present the President's budget proposal and the economic forecast for fiscal year 1988 and beyond.

The President, as well as the Congress, is compelled to comply with the deficit targets mandated by Gramm-Rudman, which certainly is a significant challenge to us all. The administration has made a number of major proposals, including several new initiatives in the area of health, welfare, trade; and we look forward to working with you on all of them.

As you are well aware, one of the first issues the committee will address this year is trade. What we are able to do legislatively may have less impact, particularly in the short term, than the conduct of our overall fiscal policy. I believe it is very important, Mr. Miller, that the administration and the Congress forge efforts to find acceptable solutions on both the budget and trade issues, and I look forward to your remarks.

Chairman ROSTENKOWSKI. Dr. Miller, welcome. Thank you very much for joining us. I know that you are a very busy man, but we certainly appreciate an opportunity to have you present the President's budget to this committee.

## STATEMENT OF HON. JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. MILLER. Mr. Chairman, thank you.

I know everyone on the committee is very busy. But, as you indicated, this is an important topic, and I welcome the opportunity to visit with you about it.

I would like to respond to a couple of points you made, Mr. Chairman. We can go into more detail at your convenience whenever you like.

Although technically the President's budget does not meet the Gramm-Rudman-Hollings targets in fiscal years 1989 and beyond, the shortfall is small. It is the kind of thing that we can work on the following years. But that, itself, does not imply a violation of the Gramm-Rudman-Hollings law.

As you know, Mr. Chairman, the law requires us to meet the Gramm-Rudman-Hollings target for the year in question, and that is fiscal year 1988, and that is what we have done. I realize there is a difference between OMB and CBO in terms of the estimates. OMB has estimated the baseline current services deficit at $150 billion. CBO's preliminary estimate is $169 billion.

The differences between these two numbers are primarily a $10 billion shortfall in receipts, according to CBO, and that is explained mainly by the fact they have slightly lower growth assumptions than we do. They have a 2.2 percent rate of growth versus our 2.9 percent in fiscal year 1987, and they have 3.0 percent growth versus our 3.4 percent in fiscal year 1988.

There is disagreement over advanced deficiency payments. We do not plan to pay the deficiency payments in advance, as CBO believes that we will. We have total discretion in that matter under current law, and that accounts for about $4 billion. Then there is about $5 billion difference on the costing of Medicare.

Keep in mind, Mr. Chairman, this year is an anomaly in that we produced the budget a month early and the kinds of exchanges that would normally take place between OMB and CBO over the details of the President's proposals, and also over the calculations of the baseline, have not had the same airing this year because of that. And, therefore, we think that probably CBO's numbers will be subject to some revision.

In terms of the deficit reduction package, OMB estimates that $42 billion is the shortfall between $108 billion, the target, and $150 billion the current services deficit. CBO estimates the President's deficit reduction package is approximately $33 billion. They disagree with us on some of the outlay, and also some of the revenue estimates. Thus, in terms of the deficit, instead of $108 billion, CBO estimates it at something on the order of $135 billion to $140 billion.

That basically is the nature of the difference between us. Again, let me say it is not surprising that there would be differences between two estimating organizations. If you take at random any two organizations out of the blue chip estimators, for example, you are bound to get substantial differences as to the estimates of unemployment, inflation, and so forth. So, that is not very surprising.

In the past, CBO and OMB have differed. I hope we will be able to narrow the range or at least understand better the reasons for our differences in the next couple of weeks. It is true that the President's budget contains numerous proposals that have been rejected before, Mr. Chairman, by Congress. However, the President and we in the administration believe this is justified; these programmatic changes are justified. In some cases we have a different approach to these programmatic changes that I hope Congress will review very seriously.

As for whether the President is serious about the budget, you bet he is. He has indicated all along to me the need to meet the $108

billion maximum deficit target for fiscal year 1988. He has also indicated to me that his intent is to get the deficit down, and he is absolutely firm in that. Therefore, he has rejected overtures to him to revise those figures upward. He is prepared to work with Congress on this issue and looks forward to doing so.

There is a question, however, of the appropriate time to engage in such a colloquy. We have, in the administration, placed on the table a budget with what seems like almost infinite detail, and we would like to see what those who would want to get together with the President and discuss budget issues would propose as their approach.

Now, Mr. Chairman, with your permission I would like to review the testimony that I prepared. I am certainly happy to have this opportunity to review with you the President's budget for fiscal year 1988. As you know, the President's budget proposes a further reduction in the deficit, while maintaining Federal support for the core functions of government.

Specifically, the President's budget meets the Gramm-Rudman-Hollings target, a maximum deficit of $108 billion for fiscal year 1988, a reduction of $65 billion in fiscal year 1988, following a reduction of an estimated $48 billion, in fiscal year 1987. As you know, Mr. Chairman, CBO and OMB have almost precisely the same number in terms of our estimate of the deficit for fiscal year 1987.

The budget also avoids increasing the burden on the Nation's taxpayers. It reflects a bipartisan consensus to protect Social Security, provides a 3-percent real growth above the 1987 appropriated level for national defense, and reforms, reduces, or terminates an assortment of programs, saving taxpayers $19 billion in 1988 alone.

As a share of the gross national product, the deficit decline is even more dramatic, from a total of 5.3 percent of GNP in fiscal year 1986, to just 2.3 percent in fiscal year 1988. In an absolute amount, the deficit is more than cut in half in just two years, from $221 billion in fiscal year 1986, to $108 billion in fiscal year 1988.

Under the President's budget, outlays increase by $9 billion—from $1,016 billion in fiscal year 1987, to $1,024 billion in fiscal year 1988. Adjusted for inflation, spending actually declines in real terms.

The $9 billion increase in outlays reflects the net impact of: (*a*) an increase of $2 billion for net interest payments; (*b*) an increase of $11 billion for Social Security benefits; (*c*) an increase of $15 billion for national defense; and (*d*) an increase of $1 billion for major medical programs; and (*e*) a net decrease of $21 billion for other Federal spending. This decrease in outlays for other programs reflects the net impact of $13 billion in increased revenues from asset sales, privatization initiatives, and user fees, as well as a wide variety of programmatic increases and decreases.

I would like to talk at this point about the revenue measures. The President's fiscal year 1988 budget contains deficit savings of $42.4 billion. Programmatic reforms account for only $18.7 billion of these savings; the rest come from increased revenue of $22.4 billion and lower interest expense of $1.3 billion.

As you lower the deficit, you have less debt to service, and so you reduce the amount of interest expense.

Critics have latched onto the revenue figure as evidence the President has broken his promise not to raise taxes. They say the only question for fiscal year 1988 is just how big a tax increase there is going to be, not whether there will be one. Their argument appears to be based on an unusual definition of a tax—anything that raises Government revenue. Actually, under this definition, a tax decrease in the so-called upper portion of the Laffer curve, which would increase total revenue, would be judged a tax. That is not how the administration defines taxes, nor does this view comply with the usual definition.

First, the budget distinguishes between increases in receipts, which total $6.1 billion, and increases in offsetting collections, which total $16.3 billion. Offsetting collections are payments of a business type or market-oriented activities, and about $9 billion of the total stems from the sale of Government assets.

No one should confuse an asset sale, whether a Government loan or a railroad, with a tax. Certainly, the purchasers won't. They expect to receive something of value they may later resell if appropriate. Furthermore, there is no element of compulsion in these transactions, as there is with taxes. You don't have to purchase a Government asset if you don't want to.

Another distinction is that an asset sale pares down the size of government. And since many of our privatization efforts are accompanied by an end to wasteful subsidies, in the long run spending goes down as well. Asset sales are one-shot revenue increases, whereas tax increases are designed to increase the revenue stream permanently.

Another $3.2 billion in offsetting collections comes from user fees, which also clearly are not taxes, although they do constitute a permanent increase in the revenue stream. A user fee is a direct charge for a specific benefit received. Like an asset sale, but unlike a tax, a user fee does not involve compulsion. One characteristic of user fees is that they reveal how much Government programs are really worth to direct recipients in the most direct and meaningful way possible. One of the strongest arguments that a Government program is worthwhile occurs when it has a user fee and the fee covers costs. The reverse is also true, and that is one reason some beneficiaries oppose user fees.

Finally, the budget incorporates increased receipts of $6.1 billion. Do these revenues reflect a broken promise not to raise taxes? Not at all. First, more than a third of the extra receipts—$2.4 billion—is due to tighter enforcement of existing tax laws. Collecting more of the taxes already owed the government is not a tax increase.

I am sure the committee would agree with that.

Several of the reforms giving rise to increased receipts are very much like user charges, but by convention show up in the receipts portion of the Government's ledger. It has long been accepted that the Federal excise taxes on gasoline and diesel fuel, and other highway excise taxes, are in essence a user fee for consumption of federally supported roadways. Indeed, the moneys collected are deposited in a trust fund for that purpose. The budget proposes to repeal the partial exemptions from excise taxes on gasoline and diesel fuel produced from gasohol and certain alcohol fuels, and repeal the exemptions from these and other highway excise levies

provided private bus operators. The budget also proposes to end the present free ride afforded State and local governments—who now pay no tax but like every other user derive benefits from using federally assisted roadways. The repeal of these exemptions increases receipts to the highway trust fund by $0.8 billion.

The vast majority of employees of State and local governments benefit from medicare coverage under existing laws and regulations. Rather than propose excluding them from Medicare eligibility—an initiative that surely would generate howls of opposition—we propose that existing employees, like new employees under current law, contribute appropriate payments to Medicare. This increases receipts by $1.6 billion.

Likewise, many workers whose current job is not covered under Social Security—OASDHI—will be eligible for benefits because of their spouse's earnings record or short periods of work in covered employment. The proposed extension of Social Security coverage to the inactive duty earnings of Armed Forces reservists, certain students and agricultural workers, children aged 18 to 21 employed by their parents, and spouses employed by the other spouse increases receipts by $0.3 billion.

We also propose that employers pay a Social Security payroll tax on total cash tips—rather than reduce the benefits provided to such employees. Under current law, employers generally pay the Social Security payroll tax on the amount of tips considered to be wages under the Federal minimum wage law, even though the tax liability of their employees is based on the total amount of cash tips. Benefits also are based on the total amount of cash tips. This proposal would eliminate the cross subsidy from other employers and would increase receipts by $0.2 billion.

Two trust funds—those compensating victims of black lung disease and railroad retirement—presently are not sound in an actuarial sense. Therefore, the administration proposes to increase the user charge contribution by $0.5 billion. Similarly, to ensure sound financing of railroad employment benefits—the Railroad Sickness and Unemployment Insurance Fund is deeply in debt to the financially ailing rail pension fund—the budget renews the administration's proposal to extend the Federal/State unemployment insurance program to the railroad industry. This increases receipts by $0.1 billion.

Many of the remaining measures, which increase receipts by a net $0.2 billion, can be explained by similar logic. These include: the correction of a technical deficiency in the existing ad valorem tax on imports, which exempts imports with American-made components. This will ensure that the costs of services provided by the U.S. Customs Service are borne by the users of these services; the initiation of rail sector financing of a portion of windfall benefits, which will reduce the annual subsidy of some $1,100 per employee to about $820 in a sector with annual average wages of some $40,000 per rail worker; an increase in the D.C. Government employer contribution to civil service retirement as necessary to cover the full cost of the program; and increases in existing fees to recover 50 percent of Nuclear Regulatory Commission and Federal Emergency Management Administration costs for regulating nuclear powerplants.

So you be the judge. Do these revenue proposals constitute a tax increase? The answer, I submit, is a definite no.

Now, if I could move on to the issue of health care reforms. As a nation, we simply cannot afford health costs that rise at four times the rate of general inflation. Americans spent $425 billion on health care in fiscal year 1985—10.7 percent of our gross national product. Per capita, we spend more on health care than any other nation on earth—28 percent more than Canada, 52 percent more than West Germany, and 100 percent more than Japan. We must find ways to provide high-quality health care at prices people can afford.

As you all know, Federal spending on health care is growing far more rapidly than inflation and the aging of our population combined. Approximately 52 million of the Nation's poor, elderly, and disabled will have their health care needs met through these programs in fiscal year 1988—an increase of 5 million people, or 11 percent, above fiscal year 1980 levels. These programs are committed to aid approximately one in every five Americans in fiscal year 1988. In contrast, over the same fiscal year 1980 to fiscal year 1988 period, Medicare and Medicaid increased by 117 percent.

In the first half of the 1980's, Medicare expenditures increased an average of 12.4 percent a year. Only defense spending—11.9 percent—and interest costs—15 percent—grew at comparable rates. Even with the recent success in restraining health care inflation, under current law Medicare outlays are projected to escalate by 10 percent annually through fiscal year 1992, more than twice the projected average Consumer Price Index and rate of growth in the numbers of beneficiaries combined.

The President's budget proposes to slow this growth rate to 8 percent a year—a rate faster than last year's growth—through proposals designed to contain costs and to increase the efficiency of health care delivery. Even so, under this budget Medicare spending will be $104 billion by fiscal year 1992, more than 2½ times the amount spent in fiscal year 1981.

Medicare and Medicaid spending will continue to grow as a share of the President's budget, from 9.2 percent in fiscal year 1981, to 11 percent in fiscal year 1986, and to 13 percent by fiscal year 1992. Excluding interest costs and spending on Social Security and defense, under this budget Medicare's proportion of the Federal budget would double—from 12.4 percent in fiscal year 1981 to 25.4 percent in fiscal year 1992. Our proposals can only be said to provide cuts from which I believe to be an imaginary, unsustained baseline characterized by runaway growth.

As you know, through various reforms the administration and Congress have been successful in controlling hospital expenditures—which grew by only 2 percent between fiscal year 1985 and fiscal year 1986, after almost doubling between fiscal year 1980 and fiscal year 1985. Hospitals responded to the implementation of the prospective payment system, PPS, by becoming more economical in providing care for their patients.

At the same time, hospitals posted profits, and according to the Commission on Professional and Hospital Activities, CPHA, high-quality medical care has been maintained. Specifically, CPHA

found that PPS did not change the quality of care delivered to either Medicare or non-Medicare patients.

In part because of, and in part despite of, the facts I just mentioned, the administration's goals remain very much the same as fiscal year 1982. The administration intends to promote competition, capitation, and other reforms that rely on private markets to stimulate health care service efficiency and enhance the quality of care. As part of this effort, we plan to increase choices for beneficiaries and providers alike.

We want to build on our modest success in restraining hospital payments; we want to begin changing the inflationary incentives of physician payments; and we want to ensure the quality of care.

For example, we are proposing to expand opportunities for Medicare beneficiaries to enroll in a wider range of private health benefits organizations. We want to establish a series of demonstration projects to explore ways that Medicare can benefit from innovative private sector arrangements. These projects will generate negotiated provider agreements for physician services delivered outside the hospital.

Standing by our goal to change the inflationary incentives of open-ended cost reimbursement of hospital capital, we will phase capital into the prospective payment system rates over the next 10 years. As specified by Congress, our phase-in will remain budget-neutral to the congressionally set levels for fiscal year 1988 and fiscal year 1989.

We propose to restore the authority of the Secretary of Health and Human Services to update payments under the prospective payment system. As you know, this authority was suspended for fiscal year 1988 by the fiscal year 1987 Reconciliation Act. Under our proposal, using the most current information available, the PPS update would be set at an amount necessary for the efficient and effective delivery of medically appropriate, high-quality care. For planning purposes, average hospital payments are projected to increase 2.5 percent in fiscal year 1988. That is what is in the budget.

The President's budget also includes a proposal to increase modest payments made by current Medicare beneficiaries. Specifically, we would index for inflation the present $75 deductible a beneficiary pays before Medicare coverage for physician services begins. Our proposed increase to $77 for fiscal year 1988 is clearly warranted. The deductible currently remains frozen at its fiscal year 1982 level, which in real terms is less than half the deductible in effect 20 years ago. Beneficiary income—Social Security—already is inflation indexed; it is proper for the Medicare deductible to be inflation indexed, as well.

We will also propose to increase the supplementary medical insurance, SMI, premium for new enrollees only. Current enrollees would continue to pay 25 percent of costs, even though when SMI began the premium covered 50 percent of costs. We propose that new enrollees pay 35 percent of costs. We believe that new enrollees can easily afford this modest increase in premiums. Many realize a higher standard of living once retired, and Social Security benefits for new enrollees are higher than ever.

As indicated earlier, we also propose that coverage of Medicare be extended to current, as well as new, State and local employees. As mentioned earlier, under current law many State and local employees become eligible for Medicare on the basis of spouse participation or short work periods even though they have not contributed their fair share to the Hospital Insurance Trust Fund. Our proposal also assures medicare coverage to State and local employees who now have no opportunity to enroll.

Controlling physician costs has proven to be one of our most difficult challenges. Despite the vigorous efforts of Congress and the administration, Federal expenditures for physicians grew by 15.7 percent annually between fiscal year 1980 and fiscal year 1985. During the fiscal year 1986 congressional freeze on physician charges, spending on physician services grew 8.5 percent—even when there was a freeze, they grew by 8.5 percent—while the number of beneficiaries grew by only 2 percent, and hospital admissions actually declined by 2 percent. Absent any fundamental reform of physicial payment rules, spending for physicians is projected to grow 12.5 percent annually in fiscal year 1987 and beyond.

The fee-for-service reimbursement system used to pay physicians so far has been immune to the Government's best efforts to control costs. Numerous privately and publicly funded studies have shown that from the standpoint of medicare, fee-for-service reimbursement is inherently inflationary, rewards the minority of physicians who provide medically unnecessary services, and thereby penalizes the majority of doctors whose primary interest is patient care.

We propose to reform Medicare's payment mechanism for radiologists, anesthesiologists, and pathologists, RAPs, by making medicare pay an average area price for hospital-based physician services. The area price will be determined by using actual physician billing information and calculating the average amount paid for each physician service. By paying an average price for each physician practice area, variations in cost reflecting different patterns of medical practice will be retained.

Our proposal will encourage hospital-based doctors to make a bias-free decision whether to return to the traditional relationships that existed prior to the imposition of Medicare rules. Before the creation of Medicare's split billing rules in fiscal year 1965, most hospital-based physicians billed through the hospital or were on salary, rather than billed on a fee-for-service basis. The administration's proposal does not change current Medicare assignment rules. All physicians, including RAP's, will continue to be able to bill beneficiaries above Medicare's reasonable charges. Doctor-patient relationships will not be altered. Hospital-based doctors will continue to provide their services directly to patients or in conjunction with other doctors. And quality of care will not be affected. I cannot believe a doctor on salary performs his or her work less diligently than he or she would if reimbursed by fee-for-service.

In summary, we think these proposals are solid, realistic, and very much needed. We are carefully changing the perverse incentives that contribute to progressively inefficient service delivery and unsustainable Federal spending. To obtain these goals, true reforms are necessary. We, in the administration, look forward to working with you in Congress toward this end.

Before leaving the topic of health care reforms, Mr. Chairman, allow me to comment briefly on the difference between the Congressional Budget Office (CBO), and Office of Management and Budget (OMB), estimates of the Medicare baseline. As you know, CBO's preliminary fiscal year 1988 baseline for Medicare is $5.4 billion higher than the administration's estimate. CBO projects that Medicare spending will increase by over 14 percent in fiscal year 1988, following increases of 7 percent in fiscal year 1986 and 4 percent in fiscal year 1987. The administration believes that such extraordinary growth will not occur and that the OMB estimate, based upon the advice of the Medicare actuaries, is far more realistic. Let me explain.

The OMB versus CBO difference results in large part from three factors: CBO's different assumptions from the Medicare actuary about bill processing times under provisions of the Omnibus Budget Reconciliation Act of 1986 increases the baseline by $1.4 billion; the Treasury data on fiscal year 1986 spending used by CBO yielded estimates $1 billion higher than the more recent data that the Medicare actuary received from the Medicare intermediaries; CBO's overall projected Hospital Insurance Fund growth rate is higher than the administration's projection, contributing over $1.5 billion to the higher CBO Medicare estimate.

For obvious reasons, we look forward to seeing CBO's final appraisal of the President's budget in this area.

Now let me turn to welfare reforms.

Because I know the committee is interested in welfare issues, I want to draw to your attention two interrelated proposals in the budget that deal with the population receiving aid to families with dependent children, or AFDC. Both of these proposals are based on landmark research that shows that those most likely to stay on the AFDC rolls for a long time are young, unmarried mothers with young children. Both our proposals are designed to prevent welfare dependency and increase the self-sufficiency of AFDC recipients.

The first proposal is for a new program in AFDC: Greater Opportunities through Work. "GROW" is the acronym. This proposal will give States substantial flexibility to structure programs of work-related activities designed to prevent and reduce welfare dependency. It will replace current authorities for the work incentives program (WIN), WIN demonstrations, community work experience programs, grant diversion, and employment search with a single authority.

Under GROW, the Federal law that exempts mothers with children under age 6 from participation in work-related activities will be eliminated. This change will mean that those recipients most likely to stay on the rolls for a long time no longer will be exempt from activities designed to increase self-sufficiency.

Teenage AFDC recipients who have not completed high school will be able to meet participation requirements by staying in or returning to school. Older recipients will be able to participate in a variety of activities, including job search, work experience, remedial education, training under the Job Training Partnership Act, time-limited training directed at immediate employment, and other State-designed activities approved by the Secretary of Health and Human Services.

States will reach 20-percent participation in fiscal year 1988, rising to 60 percent by fiscal year 1992. Higher target rates for teenage recipients will be set within these overall standards.

Fifty percent Federal matching funds for work-related activities, excluding education and training, and for support services for participants in all activities will be provided out of AFDC administrative funds. Research and evaluation funds also are provided to develop outcome-oriented performance standards that do not lead to "creaming", which has been a problem in most efforts designed to improve the self-sufficiency of AFDC recipients—these standards will be integrated into GROW as soon as they can be developed.

While GROW will save money in the longer term, in the first year costs will slightly exceed the savings expected.

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This proposal is intended to allow those closest to such problems to put together the best combination of services to help youth who suffer from illiteracy and a lack of jobs skills. These youth are the ones most seriously at risk of failing to participate fully in our society and having to turn to AFDC for support.

The President has requested $800 million for this program in fiscal year 1988—$50 million more than in the fiscal year 1987 enacted appropriation for the summer youth employment program. These funds will be targeted to areas where this youth problem is most severe.

The AFDC youth training proposal will be coordinated with GROW. Taken together, we believe these two programs will provide meaningful assistance to the AFDC population in general and particularly to those who can benefit from early interventions to prevent long-term welfare dependency.

I'd like to talk about restoring America's competitiveness. The ability of our Nation to meet global competition, to provide for our national security, and to improve the quality of life for all our citizens depends heavily, in the long run, upon national investments in science and technology. The Nation's future strengths in global markets will depend on the allocation of national resources to the generation of new knowledge and the effective and timely transfer of this new knowledge to specific applications.

To aid in meeting this goal, the administration recommends further increases in federally supported basic research. This proposal includes an increase of about 18 percent in funding for basic research for the National Science Foundation in fiscal year 1988 and a doubling of this budget for fiscal year 1992.

Second, an increase of about 22 percent in basic research activities of the National Aeronautics and Space Administration, including the initiation of two new science and technology programs.

Third, an increase of about 15 percent for the general science programs of the Department of Energy, permitting better use of basic research facilities.

Support for basic research, particularly at universities, is key to generating sufficient new knowledge to ensure our leadership in technological innovation. Quite appropriately, the Federal Government has assumed a major role in the financing of basic research. This support will increase by 76 percent between fiscal year 1982 and fiscal year 1988—an average annual increase of nearly 10 percent.

A second key element in assuring our leadership in science and industry is the future availability of high-quality scientists and engineers. Funding basic research in academic institutions is an effective way of expanding the pool of trained scientists and engineers. The administration proposes to increase the emphasis on research programs that would contribute to the development of such human capital. This emphasis will be reflected in the proposed new basic science and technology centers, in the new superconducting super collider just announced by the President, and in a variety of ongoing programs of the National Science Foundation, including the engineering research centers, the advanced scientific computing centers, the graduate fellowship program, and the programs to improve student research and increase funds for scientific equipment at undergraduate institutions. Increased support will also be provided for other NSF programs aimed at improving the quality of pre-college science and mathematics education.

The Federal Government should also encourage the transfer to the private sector of existing technology and new technology created in Federal laboratories. Both are of little practical use unless they are made available to the private sector to permit applications in the marketplace. To achieve this goal, there will be increased Federal efforts to transfer the results of federally supported research and development both through greater use of incentives for federally employed scientists and engineers and through the exchange of scientists and engineers between Government and industry.

Finally, the administration proposes to strengthen the Nation's leading edge technologies to meet other national needs. Examples include: a new civil space technology initiative, together with previously planned funding increases to deploy the space station, develop the national aerospace plane, and foster the commercial development of space; the strategic defense initiative and associated Department of Defense initiatives involving strategic computing and very high speed integrated circuits; and support for cooperative research and development ventures by the Department of Energy to encourage greater private sector participation in fossil, solar, and energy conservation research and development.

Mr. Chairman and members of the committee, that completes my statement. Now I shall be happy to address your questions.

[The prepared statement follows:]

PREPARED STATEMENT

of

JAMES C. MILLER III

DIRECTOR

OFFICE OF MANAGEMENT AND BUDGET

before the

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

FEBRUARY 3, 1987

Mr. Chairman and Members of the Committee: It's an honor to have this opportunity to discuss with you the President's budget for FY 1988.

As you know, the President's budget proposes a further reduction in the deficit while maintaining Federal support for the core functions of Government. Specifically, the budget:

-- Meets the Gramm-Rudman-Hollings FY 1988 deficit limit of $108 billion -- a reduction of $65 billion in FY 1988, following a reduction of $48 billion in FY 1987;

-- Avoids increasing the Nation's tax burden;

-- Reflects the bipartisan consensus to protect social security;

-- Provides 3 percent real growth (above the FY 1987 appropriated level) in funding for national defense; and

-- Reforms, reduces, or terminates an assortment of programs, saving taxpayers $19 billion in FY 1988 alone.

As a share of gross national product (GNP), the deficit decline is dramatic -- from a total of 5.3 percent of GNP in FY 1986 to just 2.3 percent in FY 1988. In absolute amount, the deficit is more than cut in half in just two years -- from $221 billion in FY 1986 to $108 billion in FY 1988.

Under the President's budget, outlays increase by $9 billion -- from $1,016 billion in FY 1987 to $1,024 billion in FY 1988. Adjusted for inflation, spending actually declines in real terms.

The $9 billion increase in outlays reflects the net impact of: (a) an increase of $2 billion for net interest payments; (b) an increase of $11 billion for social security benefits; (c) an increase of $15 billion for national defense; (d) an increase of $1 billion for major medical programs; and (e) a net decrease of $21 billion for other Federal spending. This decrease in outlays for other programs reflects the net impact of $13 billion in increased

revenues from asset sales, privatization initiatives, and user fees, as well as a wide variety of programmatic increases and decreases.

Revenue Increases

The President's FY 1988 budget contains deficit savings of $42.4 billion. Programmatic reforms account for only $18.7 billion of these savings; the rest come from increased revenue of $22.4 billion and lower interest expense of $1.3 billion.

Critics have latched onto the revenue figure as evidence the President has broken his promise not to raise taxes. They say the only question for FY 1988 is just how big a tax increase there's going to be, not whether there will be one. Their argument appears to be based on an unusual definition of a tax -- anything that raises Government revenue. That is not how the Administration defines taxes, nor does this view comply with the usual definition.

First, the budget distinguishes between increases in receipts, which total $6.1 billion, and increases in offsetting collections, which total $16.3 billion. Offsetting collections are payments of a "business-type or market-oriented nature," and about $13.0 billion of the total stems from the sale of Government assets. No one should confuse an asset sale, whether a Government loan or a railroad, with a tax. Certainly, the purchasers won't. They expect to receive something of value they might later resell if appropriate. Furthermore, there is no element of compulsion in these transactions, as there is with taxes. You don't have to purchase a government asset if you don't want to.

Another distinction is that an asset sale pares down the size of government. And since many of our privatization efforts are accompanied by an end to wasteful subsidies, in the long run spending goes down as well. Asset sales are "one-shot" revenue increases, whereas tax increases are designed to increase the revenue stream permanently.

The remaining $3.2 billion in offsetting collections comes from user fees, which also clearly are not taxes, although they do constitute a permanent increase in the revenue stream. A user fee is a direct charge for a specific benefit received. Like an asset sale, but unlike a tax, a user fee does not involve compulsion. One characteristic of user fees is that they reveal how much government programs are really worth to direct recipients in the most direct and meaningful way possible. One of the strongest arguments that a government program is worthwhile occurs when it has a user fee and the fee covers costs. The reverse is also true, and that is one reason some beneficiaries oppose user fees.

Finally, the budget incorporates increased receipts of $6.1 billion. Do these revenues reflect a broken promise not to raise taxes? Not at all. First, more than a third of the extra receipts -- $2.4 billion -- is due to tighter enforcement of existing tax laws. Collecting more of the taxes already owed the Government is not a tax increase.

Several of the reforms giving rise to increased receipts are very much like user charges, but by convention show up in the receipts portion of the Government's ledger. It has long been accepted that the Federal excise taxes on gasoline and diesel fuel, and other highway excise taxes, are in essence a user fee for consumption of Federally-supported

roadways. Indeed, the monies collected are deposited in a trust fund for that purpose. The budget proposes to repeal the partial exemptions from excise taxes on gasoline and diesel fuel produced from gasohol and certain alcohol fuels, and repeal the exemptions from these and other highway excise levies provided private bus operators. The budget also proposes to end the present free ride afforded State and local governments -- who now pay no tax but like every other user derive benefits from using Federally-assisted roadways. The repeal of these exemptions increases receipts to the highway trust fund by $0.8 billion.

The vast majority of employees of State and local governments benefit from Medicare coverage under existing laws and regulations. Rather than propose excluding them from Medicare eligibility -- an initiative that surely would generate howls of opposition -- we propose that existing employees, like new employees under current law, contribute appropriate payments to Medicare. This increases receipts by $1.6 billion.

Likewise, many workers whose current job is not covered under social security (OASDHI) will be eligible for benefits because of their spouse's earnings record or short periods of work in covered employment. The proposed extension of social security coverage to the inactive duty earnings of Armed Forces reservists, certain students and agricultural workers, children aged 18-21 employed by their parents, and spouses employed by the other spouse increases receipts by $0.3 billion.

We also propose that employers pay the social security payroll tax on total cash tips -- rather than reduce the benefits provided to such employees. Under current law employers generally pay the social security payroll tax on the amount of tips considered to be wages under the Federal minimum wage law, even though the tax liability of their employees is based on the total amount of cash tips. Benefits also are based on the total amount of cash tips. This proposal would eliminate the cross subsidy from other employers and would increase receipts by $0.2 billion.

Two trust funds -- those compensating victims of "black lung disease" and railroad retirement -- presently are not sound in an actuarial sense. Therefore, the Administration proposes to increase the "user charge" contribution -- by $0.5 billion. Similarly, to ensure sound financing of railroad unemployment benefits -- the Railroad Sickness and Unemployment Insurance Fund is deeply in debt to the financially ailing rail pension fund -- the budget renews the Administration's proposal to extend the Federal/State unemployment insurance program to the railroad industry. This increases receipts by $0.1 billion.

Many of the remaining measures, which increase receipts by a net $0.2 billion, can be explained by similar logic. These include:

-- The correction of a technical deficiency in the existing ad valorem tax on imports, which exempts imports with American-made components. This will ensure than the costs of services provided by the U.S. Customs Service are borne by the users of these services.

-- The initiation of rail sector financing of a portion of windfall benefits, which will reduce the annual subsidy of some $1,100 per employee to about $820 in a sector with annual average wages of some $40,000 per rail worker.

-- An increase in the D.C. government employer contribution to civil service retirement as necessary to cover the full cost of the program.

-- Increases in existing fees to recover 50 percent of Nuclear Regulatory Commission and Federal Emergency Management Administration costs for regulating nuclear power plants.

Now, you be the judge. Do these revenue proposals constitute a tax increase? The answer, I submit, is a definite no.

Health Care Reforms

As a nation, we simply cannot afford health costs that rise at four times the rate of general inflation. Americans spent $425 billion on health care in FY 1985 -- 10.7 percent of our gross national product. Per capita, we spend more on health care than any other nation on earth -- 28 percent more than Canada, 52 percent more than West Germany, and 100 percent more than Japan. We must find ways to provide high-quality health care at prices people can afford.

As you all know, Federal spending on health care is growing far more rapidly than inflation and the aging of our population combined. Approximately 52 million of the Nation's poor, elderly, and disabled will have their health care needs met through these programs in FY 1988 -- an increase of 5 million people, or 11 percent, above FY 1980 levels. These programs are expected to aid approximately one in every five Americans in FY 1988. In contrast, over the same FY 1980 to FY 1988 period, Medicare and Medicaid increased by 117 percent.

In the first half of the 1980s, Medicare expenditures increased an average of 12.4 percent a year. Only defense spending (11.9 percent) and interest costs (15 percent) grew at comparable rates. Even with the recent success in restraining health care inflation, under current law Medicare outlays are projected to escalate by 10 percent annually through FY 1992, more than twice the projected average Consumer Price Index and rate of growth in the numbers of beneficiaries combined.

The President's budget proposes to slow this growth rate to 8 percent a year -- a rate faster than last year's growth -- through proposals designed to contain costs and to increase the efficiency of health care delivery. Even so, under this budget Medicare spending will be $104 billion by FY 1992 -- more than two-and-one-half times the amount spent in FY 1981.

Medicare and Medicaid spending will continue to grow as a share of the President's budget -- from 9.2 percent in FY 1981, to 11 percent in FY 1986, and to 13 percent by FY 1992. Excluding interest costs and spending on social security and defense, under this budget Medicare's proportion of the Federal budget will double -- from 12.4 percent in FY 1981 to 25.4 percent in FY 1992. Our proposals can only be said to provide "cuts" from which I believe to be an imaginary, unsustainable baseline characterized by runaway growth.

As you know, through various reforms the Administration and Congress have been successful in controlling hospital expenditures -- which grew by only 2 percent between FY 1985 and FY 1986, after almost doubling between FY 1980 and FY

1985. Hospitals responded to the implementation of the prospective payment system (PPS) by becoming more economical in providing care for their patients. At the same time, hospitals posted profits, and, according to the Commission on Professional and Hospital Activities (CPHA), high-quality medical care has been maintained. Specifically, CPHA found that PPS did not change the quality of care delivered to either Medicare or non-Medicare patients.

In part because of and, in part, despite of, the facts I just mentioned, the Administration's goals remain very much the same as FY 1981. The Administration intends to promote competition, capitation, and other reforms that rely on private markets to stimulate health care service efficiency and enhance the quality of care. As part of this effort, we plan to increase choices for beneficiaries and providers alike.

We want to build on our modest success in restraining hospital payments, we want to begin changing the inflationary incentives of physician payments, and we want to ensure the quality of care.

For example, we are proposing to expand opportunities for Medicare beneficiaries to enroll in a wider range of private health benefits organizations. We want to establish a series of demonstration projects to explore ways that Medicare can benefit from innovative private sector arrangements. These projects will create negotiated provider agreements for physician services delivered outside the hospital.

Standing by our goal to change the inflationary incentives of open-ended cost reimbursement of hospital capital, we will phase capital into the prospective payment system rates over the next 10 years. As specified by Congress, our phase-in will remain "budget neutral" to the Congressionally-set levels for FY 1988 and FY 1989.

We propose to restore the authority of the Secretary of Health and Human Services to update payments under the prospective payment system; as you know, this authority was suspended for FY 1988 by the FY 1987 Reconciliation Act. Under our proposal, using the most current information available, the PPS update would be set at an amount necessary for the efficient and effective delivery of medically-appropriate, high-quality care. For planning purposes, average hospital payments are projected to increase 2.5 percent in FY 1988.

The President's budget also includes a proposal to increase modestly payments made by current Medicare beneficiaries. Specifically, we would index for inflation the present $75 deductible a beneficiary pays before Medicare coverage for physician services begins. Our proposed increase to $77 for FY 1988 is clearly warranted. The deductible currently remains frozen at its FY 1982 level, which in real terms is less than half the deductible in effect 20 years ago. Beneficiary income -- social security -- already is inflation indexed; it is proper for the Medicare deductible to be inflation indexed as well.

We also propose to increase the supplementary medical insurance (SMI) premium for new enrollees only. Current enrollees would continue to pay 25 percent of costs, even though when SMI began the premium covered 50 percent of costs. We propose that new enrollees pay 35 percent of costs. We believe that new enrollees can easily afford this modest increase in premiums. Many realize a higher standard of living once retired, and social security benefits for new

enrollees are higher than ever.

As indicated earlier, we also propose that coverage of Medicare be extended to current (as well as new) State and local employees. As mentioned earlier, under current law many State and local employees become eligible for Medicare on the basis of spouse participation or short work periods even though they have not contributed their fair share to the Hospital Insurance Trust Fund. Our proposal also assures Medicare coverage to State and local employees who now have no opportunity to enroll.

Controlling physician costs has proven to be one of our most difficult challenges. Despite the vigorous efforts of Congress and the Administration, Federal expenditures for physicians grew by 15.7 percent annually between FY 1980 and FY 1985. During the FY 1986 Congressional freeze on physician charges, spending on physician services grew 8.5 percent, while the number of beneficiaries grew by only 2 percent and hospital admissions actually declined by 2 percent. Absent any fundamental reform of physician payment rules, spending for physicians is projected to grow 12.5 percent annually in FY 1987 and beyond.

The fee-for-service reimbursement system used to pay physicians so far has been immune to the government's best efforts to control costs. Numerous privately and publicly funded studies have shown that from the standpoint of Medicare, fee-for-service reimbursement is inherently inflationary, rewards the minority of physicians who provide medically unnecessary services, and thereby penalizes the majority of doctors whose primary interest is patient care.

We propose to reform Medicare's payment mechanism for radiologists, anethesiologists, and pathologists (RAPs) by having Medicare pay an average area price for hospital-based physician services. The area price will be determined by using actual physician billing information and calculating the average amount paid for each physician service. By paying an average price for each physician practice area, variations in costs reflecting different patterns of medical practice will be retained.

Our proposal will encourage hospital-based doctors to make a bias-free decision whether to return to the traditional relationships that existed prior to the imposition of Medicare rules. Before the creation of Medicare's split billing rules in FY 1965, most hospital-based physicians billed through the hospital or were on salary, rather than billed on a fee-for-service basis. The Administration's proposal does not change current Medicare assignment rules. All physicians, including RAPs, will continue to be able to bill beneficiaries above Medicare's "reasonable charges". Doctor-patient relationships will not be altered. Hospital-based doctors will continue to provide their services directly to patients or in conjunction with other doctors. And quality of care will not be affected. I cannot believe a doctor on salary performs his or her work less diligently than he or she would if reimbursed by fee for service.

In summary, we think these proposals are solid, realistic, and very much needed. We're carefully changing the perverse incentives that contribute to progressively inefficient service delivery and unsustainable Federal spending. To obtain these goals, true reforms are necessary. We in the Administration look forward to working with you in Congress toward this end.

Before leaving the topic of health care reforms, Mr.Chairman, allow me to comment briefly on the difference between the Congressional Budget Office (CBO) and Office of Management and Budget (OMB) estimates of the Medicare baseline. As you know, CBO's preliminary FY 1988 baseline for Medicare is $5.4 billion higher than the Administration's estimate. CBO projects that Medicare spending will increase by over 14 percent in FY 1988, following increases of 7 percent in FY 1986 and and 4 percent in FY 1987. The Administration believes that such extraordinary growth will not occur and that the OMB estimate, based upon the advice of the Medicare actuaries, is far more realistic. Let me explain.

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The AFDC Youth Training proposal will be coordinated with GROW. Taken together, we believe these two programs will provide meaningful assistance to the AFDC population in general and particularly to those who can benefit from early interventions to prevent long-term welfare dependency.

## Restoring America's Competitiveness

The ability of our Nation to meet global competition, to provide for our national security, and to improve the quality of life for all our citizens depends heavily, in the long run, upon national investments in science and technology. The Nation's future strengths in global markets will depend on the allocation of national resources to the

generation of new knowledge and the effective and timely transfer of this new knowledge to specific applications.

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-- A new civil space technology initiative, together with previously planned funding increases to deploy the space station, develop the national aerospace plane, and foster the commercial development of space;

-- The strategic defense initiative and associated Department of Defense initiatives involving strategic computing and very high speed integrated circuits; and

-- Support for cooperative research and development ventures by the Department of Energy to encourage greater private sector participation in fossil, solar, and energy conservation research and development.

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Mr. Chairman and Members of the Committee: that completes my statement. Now I shall be happy to address your questions.

Chairman ROSTENKOWSKI. Thank you, Dr. Miller.

Dr. Miller, I was under the impression that section 214(b) of the Gramm-Rudman-Hollings Balanced Budget Act required that the budget transmitted by the President meet or exceed the deficit targets for each of the next 5 years.

Last year, your budget met the target for each year.

Mr. MILLER. Yes.

Chairman ROSTENKOWSKI. Why did the President's budget sent this year violate the target for every year but 1988?

Mr. MILLER. Mr. Chairman, first of all, keep in mind we did the budget a month early this year. It was very hard for us to do that, as you now. Congress left in October and left 107 enrolled bills. To write memos on and analyze in great detail with the President and other senior advisors the pros and cons of these bills, it was very time-consuming. I just concluded it was impossible to produce the budget by January 5, as requested by Congress the way we normally produce a budget.

I essentially said we could not do it. The leadership came down and met with the President, and beseeched him to try to produce the budget earlier.

The President and I discussed it later. He said, "Jim, I want you to get up as much as you can by January 5." That is what we did.

We had a crash program and put it together. Frankly, we had to focus on the 1988 fiscal year, because that is the year we have for the appropriations cycle.

We put together what I think is a very good budget. Our lawyers told us, though, that the provision relating to the submission of a budget in terms of the Gramm-Rudman-Hollings applied only to the year at issue—that is, fiscal year 1988.

If you will look at the detail, of course, it means that the shortfall is about roughly $20 billion for each of the out years. That could be, I think reasonably well-accommodated if there were a need to do that.

Surely we will have some opportunity to look at it again next year. I will go back to my lawyers and ask again if this is the appropriate interpretation.

Chairman ROSTENKOWSKI. Thank you, Dr. Miller.

Many of the deficit reduction proposals that are in the committee's jurisdiction are one-time savings, savings from proposals that have been previously rejected by Congress or savings due to abrogating bipartisan agreements which we met last year.

Would you summarize what portion of the $42.4 billion in savings for fiscal year 1988 has been previously rejected by the Congress, what portion represents one-time savings, what portion is savings which altered bipartisan agreements reached in the reconciliation bill of last year?

Mr. MILLER. I will be glad to give you detail. A lot of the proposals have been rejected. It is kind of hard to know precisely.

In the loan asset sales, for example, last year at this time many in Congress were raising hackles about loan asset sales and ridiculing them.

Yet, when it came to reconciliation, Congress was more than happy to take loan asset sales. We have a credit program that is somewhat an extrapolation of last year's program. Congress actual-

ly passed more asset sales than we had proposed in last year's budget.

A good portion of the revenue increases that we have in the budget are one-time savings. We have $6.1 billion on the top line, on the receipt side. That is not a one-time savings. We have savings in the form of user charges, $3.2 billion of the $22.2 billion total. Those would continue out into the future. Much of the rest, however, are one-time savings.

As far as the bipartisan agreements, Mr. Chairman, if I was a party to the bipartisan agreement, (*a*) I would probably know the detail of it, and, (*b*) it wouldn't bind the President.

I will be glad to work with your staff in trying to ascertain what the dimensions of that definition you would prefer for me to respond to.

Chairman ROSTENKOWSKI. I was under the impression that the reconciliation bills reflect bipartisan agreements by both the House and Senate.

One last question, Dr. Miller.

If we raise gas user fees 25 or 30 cents, would that be characterized as a tax?

Mr. MILLER. Well, I think my discussion contained in my testimony speaks for itself. It really is a user fee. It almost always has been accepted as a user fee. I wouldn't call it a tax. It is something different from what the President means when he talks about a tax increase.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Thank you, Dr. Miller. I think your statement is certainly a very comprehensive one. It covered most of the ground. The administration and CBO both have stated that the economic forecasts of moderate real growth in fiscal years 1987 and 1988 depends on the improvement in the trade deficit.

What factors can you point to as an indication that this actually might happen?

Mr. MILLER. I expect the trade deficit to go down substantially in this coming year for a couple of reasons.

One, we have had a substantial appreciation of foreign currencies relative to the dollar. There tends to be a lag effect between the exchange rates and the effects on the real side, on the trade side, the so-called J-curve.

The effect has taken place more slowly than we anticipated, but perhaps the December figures are an indication that it is finally upon us and the effect will be rather significant.

I would, frankly, rather see our closing the trade deficit by increasing exports more than by diminishing imports. A key reason there, of course, is increased exports add to our gross national product and our rate of growth.

I think we will see a good healthy rate of growth this coming year. I think the effects of the oil price reduction—the slow rebound from that had adverse consequences last year and dislocations that showed up in the GNP.

The lower price has stimulated investment that will be showing up this year. I think it is crucial we keep this expansion going.

We are in the fifth year of an expansion, the second longest in postwar history. I think we could do things to jeopardize that expansion and ought to avoid them.

Mr. DUNCAN. Are you talking about the dollar weakening? Here where we have been on the trade matter, we talk about the strong dollar affecting us. Are there dangers for a free-fall in the value of the dollar?

Mr. MILLER. I wouldn't want to—since the dollar discussions are so sensitive these days, we in the administration have agreed that only the Secretary of the Treasury will speak to the dollar, or the President.

I just wouldn't want to comment or imply what the administration thought was the proper level of the dollar right now.

I think terms like "free-fall" are the kind of characterization that is made that we do not think would be appropriate.

Mr. DUNCAN. I understand your reluctance to discuss that. I appreciate the fact.

The administration——

Mr. MILLER. In following up your previous question, I should have mentioned that one of the reasons I think we will see some progress in the trade deficit is, as we get the financial deficit, the budget deficit under control—as you know, they are linked—we will have an easier time getting the trade deficit under control.

Of course, it is linked around the fact if you get the trade deficit under control, you have an increase in exports and an increase in the GNP. That feeds back to making it easier to reduce the budget deficit. It is all intertwined.

We have to be careful not to upset one of those connectors.

Mr. DUNCAN. The administration intends to produce a new initiative in catastrophic health coverage. Last week Secretary Bowen testified on his recommendations to the President and stated the administration was still debating the final package to be submitted to Congress.

Can you give us some possible insight as to the timing and the outcome?

Mr. MILLER. As the President has indicated, Congressman, essentially, he has four criteria. First, it must be effective; second, it must recognize the distinct roles of private insurance, Medicare and Medicaid in medical care; should be voluntary, and thus shouldn't become a new entitlement program, and last it should be budget neutral.

Obviously, this is a matter of concern to members of the administration. It is a very complicated issue.

It was discussed when Secretary Bowen made his presentation. The President, I anticipate, will shortly be making a decision on what form he will recommend to Congress that this catastrophic insurance program take.

He is, as you know, committed to making some change. Members of the administration are meeting about this.

Mr. DUNCAN. Through the year, every time we thought about catastrophic health insurance, everyone started loading it up with different things. We ended up with nothing.

I hope this year we will not overload it and end up with a good program. I think it is a very, very important one.

Thank you, Dr. Miller.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Thank you, Mr. Chairman.

Doctor, you are the agenda for this year. I think the most important part of the whole agenda that we face—I am not talking about you personally, but what you represent—the budget.

I subscribe to Gramm-Rudman because I think that is the most rational way we can get to the elimination of the deficits that we now have. It is a rational, human way to get there.

I read and have seen many things in the news media that say your budget was dead on arrival. Before I make such a conclusion, let me ask you about some of the assumptions that you make and some of the places where we actually are.

Mr. MILLER. Yes, sir.

Mr. GIBBONS. What is your assumption in your budget for the GNP growth rate and where are we now in the GNP growth rate?

Mr. MILLER. Mr. Gibbons, I have a funny feeling in my stomach when you characterize me as the "agenda for the coming year", and then suggest that before you announce the budget is dead on arrival.

Mr. GIBBONS. I didn't pronounce it dead. Some of your critics did.

Mr. MILLER. I appreciate the fact you have an open mind about this.

We assume that the rate of real growth in GNP in 1987 will be 3.2 percent and 3.7 percent in 1988.

Mr. GIBBONS. You are assuming a 3.2-percent-plus growth in the GNP. Where are we now? How fast are we growing now?

Mr. MILLER. We are less than that, less than 3 percent.

Mr. GIBBONS. We are less than 2 percent now?

Mr. MILLER. No. We are over 2 percent real growth. We have had the first preliminary data for the fourth quarter of 1986, which was a big disappointment.

However, we do feel when that is revised it will probably be higher for a couple of reasons. We have had substantial export——

Mr. GIBBONS. How about interest? What is your interest assumption for your budget?

Mr. MILLER. Interest rates on 90-day Treasury bills are forecast to be 6 percent in 1986; 5.4 percent in 1987; 5.6 in 1988.

Mr. GIBBONS. You are going to drop down to an interest of 5.4 from about 6 percent now?

How about your unemployment rate? What is the unemployment rate that you assume for 1988? What is it now in 1987?

Mr. MILLER. 6.3 percent in 1988, 6.9 percent in 1986, and 6.7 percent in 1987.

Mr. GIBBONS. In 1987 it is 6 point—I am sorry.

Mr. MILLER. 6.7 in 1987.

Mr. GIBBONS. I missed that.

Mr. MILLER. Let me speak more loudly.

We assume that after we have the final figures, the average unemployment rate for 1986 will be 6.9 percent. For 1987, it will be 6.7 percent, and for 1988, 6.3 percent. These are calendar years, not fiscal years. That information is on page 2-4 of the budget.

Mr. GIBBONS. What do you estimate the trade deficit will be for—well, this last year, of course, it was $169 billion.

For 1987, what do you think the trade deficit will be?

Mr. MILLER. I don't have the figure before me.

Mr. GIBBONS. I—you have optimistic assumptions there.

Mr. MILLER. Mr. Gibbons, if you would take a look at what is called blue chip indicators—these are 50 of the largest, most prestigious forecasting firms—and array them, you would find that some are more optimistic, some of the assumptions are less optimistic. We are higher than the average, but I think if you read them and calculate a standard deviation, someone could have a two out of three probability, or confidence of 67 percent, that we would be correct.

Mr. GIBBONS. For a reason I don't understand, the American public does not seem to be as optimistic as the blue chip indicators, and the American public does not seem to be as optimistic, from what I read from Wharton—not Wharton, but the conference board—as optimistic about the future as you all are.

We have a 6 percent interest rate now, a 5.4 percent interest rate predicted for 1988. That is a pretty good drop in interest rates.

At the same, the dollar is devaluating itself in the market, and as the dollar devaluates, it tends to push interest rates up. I don't see how we come out on all those things.

Mr. MILLER. It depends very much on the demands for savings and the supply of savings and also what the Federal Reserve happens to be doing.

Mr. GIBBONS. Most of the unemployment figures have been in the 7-percent range. You are estimating they will be as good as 6.7 when you get them all together. You are showing them down to the 6.4.

Mr. MILLER, I don't say you are doing this with smoke and mirrors, but you have got—the rose-colored glasses—you are wearing them. I don't expect you to have dark glasses on for this.

I don't see how we are going to meet the budget targets. I just don't think—I think your assumptions are a little optimistic. How optimistic, I don't know. I hope you are right. I hope you are right. God knows, we need to be right on this. I am afraid you are optimistic. I am afraid the deficit will run larger than you anticipate.

My time has expired, unfortunately, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pickle will inquire.

Mr. PICKLE. Thank you, Mr. Chairman.

Mr. Miller, good to have you here. It is a very difficult problem we have on these budgets. I think we have to be as realistic as we can.

Last week, Secretary Bowen came before our committee, and he presented us certain options on catastrophic health. He did not make a recommendation, and the inference was that he was waiting for a recommendation from the administration.

You indicated to Mr. Duncan that you thought this would be a matter that would be considered if it met one, two, three, or four targets.

My question to you is, when do you think the administration will make a decision on catastrophic illness?

Mr. MILLER. Mr. Pickle, I shouldn't be telling you this. We are meeting with the President about it this afternoon. I do not know when he will make his final decision.

It is, as you know, a very complicated issue. There are, as you probably read, differences of view among senior members of the administration, and we want to have a complete airing of the views and discussion of the alternatives in searching out, really following the excellent work the Secretary has put up for us.

Mr. PICKLE. Mr. Miller, I am trying to get some idea. Do you think we will have a recommendation from him within the next week or two?

Mr. MILLER. I think within the next week or two, yes.

Mr. PICKLE. All right, now, that means then that there will be a different plan proposed other than what——

Mr. MILLER. Not necessarily. The only person that can decide what the President wants to recommend is the President himself, and he has not made that decision.

Mr. PICKLE. I presume from that they will be doing it soon, within the next couple of weeks. There will be a different proposal. We can assume there would have to be a difference.

Mr. MILLER. No, sir. I would urge you not to assume it will be different than the plan that the Secretary has made.

Mr. PICKLE. Let me make this observation then. I think this committee and the Finance Committee in the Senate are ready to go forward with catastrophic health insurance. I think we could have a meeting of the minds that we are ready to do something. I think it is incumbent on the administration now to get its act together because if the timing is right, we might move forward on it.

If we get caught in different proposals that might throw it back. I hope we can have something specific as soon as possible.

As you know, physicians all over the country are upset that the administration is proposing folding the RAP's under the, DRG's. You have recommended today why it ought to be done. I don't know what health policy objective you gain from it other than savings. If there is a health policy objective, I would like to know it. Now, here again, Secretary Bowen does not favor this approach, yet you are doing it, and I assume it is for savings purposes only.

Here again, there is a difference of opinion within the administration on what it is going to recommend. We need to know what is your policy. Can you shed some light on the administration's position on RAP's or is that to be determined yet?

Mr. MILLER. No. First of all, let me draw a distinction. The President did not recommend a specific catastrophic plan in the budget. It was never actually considered a budget issue because we all were going under the assumption it would be deficit neutral. So the fact that we don't have a specific catastrophic plan before you today is not connected in any way to the submission of the budget. It was never intended to be in the budget.

On the other hand, the question of the RAP proposal is in the budget and it is the President's program.

Mr. PICKLE. So that is your policy, the RAP policy?

Mr. MILLER. Absolutely.

Mr. PICKLE. Let me make a general comment. What concerns me in a lot of these budget matters, most of the time when we come out with a budget and we are going to make a certain cut, that means automatically that this committee, Ways and Means, has

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got to make the bulk of the cuts. The charts you just submitted to us on these tables show for fiscal year 1988 alone Medicare is going to have a $4.6 billion cut.

Then you go on and you list a total of savings or cuts of about $9.6 billion in 1988. Now that represents—it shows here, 23 percent of the total amount of the cuts. So what always concerns me is when they say we are going to make those big cuts in the budget, that just means to the Committee on Ways and Means and to the Health Subcommittee you are going to have to cut about 24 percent of your budget out of Medicare.

It bothers me because you have to ask yourself at some point how long can this committee keep on making the major cuts in Medicare alone. That is almost what we are doing. Do you feel that or do you disagree with that?

Mr. MILLER. I disagree with that totally because the total amounts paid under Medicare have increased dramatically, dramatically over the period of years. I keep hearing this argument about cuts in Medicare. Even under the President's budget, total expenditures for Medicare will go up, not down. Also bear in mind the cuts we propose for Medicare are changes in the payment scheme, changes in the way we handle billing for Medicare.

They are not cuts in the benefits that are bestowed under Medicare. I realize we are proposing to raise the premium from 25 percent to 35 percent for new beneficiaries, and we are also increasing by $2 the $75 deductible. But goodness, we have, I think, done extraordinarily well in our proposals to save the taxpayer, but yet not have adverse impact on Medicare beneficiaries.

So, keep in mind it is a cut from a very high figure, from a rising figure, and it is still going to be above the specific level and the cuts are not in benefits. They are cuts in costs. Goodness knows American taxpayers would want the Federal Government to find less costly ways of delivering any goods and services that it produces.

Mr. PICKLE. Well, I will conclude by saying we ought to find a better way to meet all these budget cuts than by always going back to Medicare. The figures are there. For 1988, it is a $9.6 billion cut from this committee. That represents 23 percent of the total amount. So you tell me that is really not a cut, but I see the figure. So I think we ought to be looking for other ways.

Chairman ROSTENKOWSKI. Mr. Frenzel will inquire.

Mr. FRENZEL. Thank you, Mr. Chairman. Director Miller, we appreciate you coming up here. I think we have all learned a great deal from your testimony. One of the jurisdictions of this committee is trade, but one of your proposals, which is not before this committee, is one that is of interest to me.

In your suggestion for the International Trade Administration of the Department of Commerce, you are proposing to charge a fee in 1988 for processing export licenses. Fees will be established to recover processing costs. Now, I have a number of questions about that. First of all, does the administration believe we have too many exports so we need to tax them to discourage them?

Mr. MILLER. The answer is no.

Mr. FRENZEL. The second question is does the administration believe the exporters are the cause of all the expenses involved in li-

censing, which in fact, is restricting those exporters from doing the business they would like to do anyway.

Mr. MILLER. Well look, what we are proposing is a user fee of the kind that will recover the cost directly attributable to the services they receive. It is a very very small cost. It is not going to, in my judgment, adversely affect that aspect.

Mr. FRENZEL. I want to remind you this is not a service for which the exporters of the United States have gotten down on their hands and knees and begged. As a matter of fact, the Department of Defense and others have inhibited a lot of sales on a whimsical and arbitrary basis, and most American business would like to see that law thrown out the window rather than be charged for its use.

Now, may I ask you a third question. Do you believe the extra cost will not discourage exporting businesses, especially small ones?

Mr. MILLER. Yes. I think it is such a small fee to pay that it will not have any significant effect on discouraging exports. Keep in mind that it is not quite as simple as just saying it is a big brother restraint on exports. I realize there is a difference of opinion on whether we do too much restraining or too little restraining, but I think the underlying rationale of having some filter about what we export to countries or through exports make available to our adversaries is one that is imminently defensible.

I understand that there is a difference of opinion.

Mr. FRENZEL. A final question on this point because, I would like you to present to this committee how much money you expect to raise from that. It may be in the budget, but at least ordinary mortals like myself can't find the number.

Mr. MILLER. I don't have the number off the tip of my tongue.

[The information follows:]

The planned income from these fees is $5.25 million for 1988. This estimate has been developed by multiplying the anticipated number of export licenses for 1988, 105,000, by an average fee of $50. We are seeking to develop a fee schedule that does not discourage exports nor disproportionately burden small business. Any other type of schedule would obviously be counterproductive.

Mr. FRENZEL. You can present it. Is it fair to have the user fees based on the cost of the Government processing? The reason I ask that question is the more the Department of Defense hassles the exporter, the more it will cost them. If, as happens frequently, the license applications go into somebody's back pocket down at DOD, the meter is running and the exporter will be charged more.

Do you think that is a fair way to operate, because the Government can't figure out whether to grant the license or not?

Mr. MILLER. I would say to the extent there is inefficiency in the Department of Defense or anywhere else in processing forms, we ought to attack that issue directly. But the justification for channeling a user fee for these things, I think, is respectable.

Mr. FRENZEL. I would just suggest if you want to bill it to somebody, bill it to Cap Weinberger or Dick Perle or somebody.

Mr. MILLER. Perle is leaving.

Mr. FRENZEL. Give him a bill that he can pay as a civilian.

At the administration's request Congress has raised user fees for various customs services in each of the past 2 years. In addition, Congress imposed a surcharge in last year's reconciliation bill, and

it imposed an imported oil differential in the 1986 Superfund bill. That is four times, and you are back to the well again this year.

In addition, you have proposed a tourism surcharge. I have a couple of questions. How are you going to get that surcharge past GATT members? How would the administration react if Congress provides significant additional charges in reconciliation legislation or if Congress proposed an imported oil fee?

Mr. MILLER. Well, the imported oil fee I would react to negatively. I think the President has indicated his opposition to that on a number of occasions. On the question of the duty to go to customs, if you will recollect, the administration opposed the original numbers as being far too high and being GATT illegal, and the Congress reduced the levels to a number we could accept.

We did find, perhaps, an oversight in the reconciliation process. The proposal we have is to fix the duty that was proposed. The reason it is GATT legal, of course, is it is covering the cost of the customs service that is provided. I would not characterize any of these proposals in so critical, disparaging terms.

Mr. FRENZEL. Thank you very much. I think you are doing the Lord's work in trying to reduce our spending. On the other hand, I think these kinds of surcharges are frivolous, arbitrary, and a little bit silly. They are a little bit like charging the guy in jail for his meals and for his laundry.

These people are not begging you to perform these services. We are performing them at the Government's convenience for the Government's purposes, and then turning around and telling people we ought to charge for them. I think we need to take a whole new look at the revenue side and again, I thank you for your testimony.

Mr. MILLER. Thank you.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

Dr. Miller, there are some experts and many members of Congress, both Democrats and Republicans, that don't believe we can reach our deficit goals just by decreased spending, spending cuts, using user fees, and creating asset sales. Then we come to the question of raising taxes, and it is a question of semantics. I assume somewhere along the line the President has indicated he would veto any increase in taxes.

Mr. MILLER. Several times.

Mr. RANGEL. I assume that both you and the President consider the freeze in the tax rates of upper income individuals from the reform bill, if that was frozen, that would be considered a tax increase?

Mr. MILLER. Yes.

Mr. RANGEL. In the State of the Union Message the President had indicated that he has some new ideas for the budget, but he said—that he is not going to tell us about them until he sees what we are going to do first.

Could you shed any light on what the President may have meant by that?

Mr. MILLER. I went over the President's State of the Union several times. I don't recollect language specifically to that. I think what he has indicated was that he was willing to work with Congress on the budget, but before having a summit meeting he would like to

see what people in Congress thought would be the appropriate dimensions of the program.

Mr. RANGEL. And taxes would not be a part of the meeting with the President?

Mr. MILLER. That is right. I have indicated on a number of occasions that one reason I think we are a bit gun shy about having a summit is because some of the major advocates of a summit are major advocates of a tax increase, and that is just going to be a no-win kind of get-together.

Mr. RANGEL. You have to admit that what is considered a tax as opposed to a revenue enhancement or fee is a question of semantics. In the summary of the revenue provisions that has been provided for us by the Joint Committee, we have a tax provision, an extension of Medicare, a payroll tax, FICA tax extensions, and FUTA tax extensions.

Clearly, the word "taxes" and extensions of people's liability and reductions in their disposable income run throughout the President's proposal, and of course, you don't call those taxes.

Could you describe what is immune—where we could raise money and still not come into political collision with the President? You have had a lot of imagination in what you say is not a tax. Is the only thing considered a tax an individual or corporate tax?

Mr. MILLER. Congressman, I think unfortunately I had gone through a lengthy discussion about the revenues in the President's budget, and why I did not consider them taxes before you arrived.

Mr. RANGEL. No, no, no. I was here, and I heard you, and I have read what you have said. I guess my question is what do you consider a tax? What is a tax?

Mr. MILLER. Well, a tax is designed primarily as a revenue raiser. It is not an exchange for value received as in the case of a user——

Mr. RANGEL. I didn't mean a dictionary thing. I don't have to have a problem with the President. I want to raise revenue. It is clear you have been able to raise revenue and tell us that is not a tax as you see it. What is a tax? What is the President really talking about when he says he is going to veto a tax?

Mr. MILLER. Well, I will give you some examples rather than trying to conceptualize the issue. I will give you some examples: increase in the corporate tax, yes; he would not accept. An increase in the personal tax, he would not accept. Increase in an excise tax, unless you can make an argument that it is really essentially a tax, as economists use the term, on a negative externality, he won't except, in my judgment.

An import fee, as has been suggested here, and elsewhere, he would not accept. So I hope that gives you some rough idea. You know, Congressman, if it came down to a question of you have just got to find a little bit more revenue, I think probably we could work together to find a little bit more revenue. We don't think it is necessary now. We believe that the President's budget does meet the Gramm-Rudman-Hollings target, but if it came down to finding additional revenue, I think there are areas where we could do it. But it would not be a tax increase, the variety I just described.

Mr. RANGEL. I wish you wouldn't say tax increase. I won't say tax increase, but could you suggest revenue enhancement measures

that the President would support if they were in fact necessary to meet your deficit reduction goals?

Mr. MILLER. I think I probably would be bound by what the President has told me, and that before suggesting specific alternatives to his budget, he would rather see what others here would propose as alternatives.

Mr. RANGEL. He won't show us his until we show him ours first.

Mr. MILLER. That is a little strong, but we look forward very much to seeing proposals developed.

Mr. RANGEL. I offer that as a measure to avoid collision, because it is clear that we have a problem in what is considered a tax.

Mr. MILLER. Congressman, I think, not to go out too much on a limb here, obviously there are going to be areas in some of these revenue measures the President has proposed that Mr. Frenzel just doesn't like at all, and you may decide those are unacceptable, and we have to look at some other possibilities.

I am more than happy to work with you on that. I think there are some possibilities.

Mr. RANGEL. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Ford will inquire.

Mr. FORD. Thank you, Mr. Chairman.

Mr. Miller, could I turn your attention now maybe to welfare reform for a few minutes? This is the first I am seeing the new program, GROW, that will be a part of the FDC that is being proposed by the administration. There are several things in the proposal here that seem to be very attractive, and as chairman of the Subcommittee on Public Assistance, it is the intent of that committee to maybe have a bill before the committee within the next 6 or 7 weeks in a mark-up session.

The President talked about his welfare reform package, made mention of the fact in his State of the Union Message just last week, when he called for an end to top down Federal welfare solutions, and instead, he talked about local communities are to be the source of welfare reform ideas.

Now, we see that at the same time we have a proposal, not a proposal, but your message today is very clear to us that you are going to either submit through the Office of Health and Human Services or submit a proposal to Congress that would not necessarily be top down solutions to this problem.

Which of the strategies will be submitted to the Congress—what the President talked about the other night in his State of the Union Message, or a proposal coming from the Department of Health and Human Services?

Mr. MILLER. Well, the proposal for GROW that is contained in the budget follows up on some ideas that have been discussed at some length. We do not believe it is inconsistent with the report to the President by the Office of Policy Development on welfare problems or inconsistent——

Mr. FORD. I am trying to find out which avenue will the administration be advocating? Which approach will it take?

Mr. MILLER. I think the President is going to take the approach that is in the budget. That is in the State of the Union Message, and it is also in the report that was submitted to him. What he proposes, as you know, was recommended by the report. He pro-

poses that we give States and localities more flexibility to use Federal funds, being budget neutral with respect to the funds, give them more discretion to better tailor the welfare programs to the existing situation, and from that experimentation, if you like, that effort by State and local governments who are closer to the problem and fit the resources better, we might learn something about how we might reform our system at the Federal level.

Mr. FORD. Dr. Miller, we are not in disagreement with substantial flexibility to the States. The President talked about local community demonstration programs in the State of the Union Message.

Mr. MILLER. Yes, sir.

Mr. FORD. I happen to like many of the components that I see here in your message today. We look at the WIN program in which we no longer will be funding during mid year, but we are to replace it with another program and hopefully the welfare reform package will in fact replace it.

The GROW program that you talked about seemed to be very attractive. We are going to await that from Dr. Bowen at the Department of Health and Human Services. You talk about 50 percent Federal matching funds for work related activities.

Isn't it true when we take subsistence and make self-sufficient dependency of welfare recipients a dream that will come true, recipients being self-sufficient, as you talked about in your budget, when the Federal Government will be the real benefactor, cost savings, food stamps, 100-percent funded by the Federal Government, about 54 percent of the AFDC grant dollars or Federal dollars, and you mentioned only 50 percent of matching funds for work related activities, excluding education and training.

We have been talking—and we have heard from witnesses, I guess in the past 15 months—and there has been a lot of talk about the Federal Government matching—more than a 50-percent match—maybe something in the neighborhood of 75 or 80 percent, since the Federal Government will be the big saver in the self-sufficient program that we are talking about.

Mr. MILLER. I think, Congressman, what we ought to focus on is how best to design a program to provide services to those individuals, to transfer resources to those in need that can't take care of themselves and provide an opportunity for those who want to get off welfare to do so. The payment, the sharing of the funds between the States and localities and the Federal Government, is not something that is immaculately conceived. It is something subject to negotiations and changes around the margin in a sense.

We believe that over time the Federal Government has gotten increasingly involved in the proportion of support for many of these programs, and we are particularly concerned about the support for some of the overhead in these programs. In the adoption program, for example, the overhead in some States exceeds the amount that is distributed in direct support. So I would be glad to take a look at it again, but I guess we are a little bit skiddish of opening it any further.

Mr. FORD. One final question, Dr. Miller. In this second component, the second part of your testimony on welfare reform you talk about the youth summer training program to be incorporated into

the welfare population. I have some concerns here when you talk about operating a program year around with $750 million, with an additional 50 million being added for a 12-month program versus that of a summer program that only operated for a period of 3 or 3½ months.

To add only $50 million into a program that would provide training and other work opportunities for the AFDC population, how do you see only $50 million additional in this program?

Mr. MILLER. Congressman, what we do is to give the States and localities the flexibility to be either way. So it is going to help them because they can decide whether it is more appropriate to spend the money for, say, summer jobs or spend the money for year round jobs and training, also training and development for AFDC children.

So there is a little bit more money. Again it is consistent with the welfare reform report in giving States and localities a bit more flexibility, and we can see what works best.

Mr. FORD. Thank you very much.

Mr. MILLER. Thank you, sir.

Chairman ROSTENKOWSKI. Mr. McGrath will inquire.

Mr. MCGRATH. Thank you, Mr. Chairman, and Mr. Director. I just want to make clear, because of some of the questions that have been answered here today what the intention of the administration is with respect to an oil import fee. The chairman had asked whether or not a 25-cent increase in the tax on oil at the pump would be considered to be a user fee. I think your answer was yes.

On the other hand, you responded to Mr. Frenzel that the administration still had no plans to raise the oil import fee which would be ruinous to the Northern States.

Am I correct in both of those answers?

Mr. MILLER. Yes.

Mr. MCGRATH. And just one other. On the RAP proposal and the RDGs, why just the radiologists and the anesthesiologists? Why not other hospital-oriented type physicians, osteopaths, for instance, or anybody else who might have their own hospital orientation and not just be private entrepreneurs?

Mr. MILLER. As I indicated in my testimony, before 1965 a vast majority of radiologists, and anesthesiologists and pathologists were salaried employees of hospitals.

We think in terms of efficiency that is the way it would naturally be. That is the lower cost way of providing that service. But after 1965 they found it was much more renumerative to break off and be fee for service providers. This proposal would bring them back into the historical relationship.

That is mainly the reason that they were chosen as part of the program.

Mr. MCGRATH. Well, I can see a lot of problems with that particular proposal. With the American Hospital Association in town, I am sure we are going to hear a lot about that today. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Downey will inquire.

Mr. DOWNEY. Thank you, Mr. Chairman. Dr. Miller, on Friday our counterparts in the Senate Finance Committee had a hearing on several proposals affecting the domestic oil industry. You have

been quite clear today in indicating yours and President Reagan's opposition to an oil import fee.

Is it my understanding that the President is firmly opposed to the idea of an oil import fee as a method of raising revenue, and is there any circumstance that you can foresee at this time under which the President or you would recommend an oil import fee as a way of raising revenue?

Mr. MILLER. No.

Mr. DOWNEY. Let me ask you some questions about the welfare reform proposal. I, like Mr. Ford, serve on that subcommittee and have an interest in it and find myself in the unusual position of saying something that I didn't think I would say when I came here; that is, that it seems as though the administration is recognizing part of what the problem is with youth being raised in poverty is all about, and is attempting to deal with the problem realistically.

I congratulate you. I think that the GROW program is a step in the right direction. I hope my support for it doesn't doom its chances.

Mr. MILLER. I hope it enhances the chances.

Mr. DOWNEY. I hope so, too, but I am never quite sure.

Let me ask about one of the proposals that Mr. Ford touched on, and that is the 50 percent Federal matching funds for work related activities, excluding education and training. Why did you exclude education and training? It seems that those are exponents that are important to making sure the program succeeds.

Mr. MILLER. I don't recall the rationale at the moment. I will be glad to——

Mr. DOWNEY. Could you supply that for the record?

Mr. MILLER. Yes. I will get back to you on that.

[The information follows:]

The GROW proposal would permit States to count AFDC recipients engaging in education and training activities toward the participation standard, although it does not include Federal matching funds for these activities. GROW would, however, finance supportive services, such as child care and transportation, for these recipients.

Matching funds are not provided for education and training because these are ongoing activities already financed by State and local programs, some of which are federally assisted; Federal AFDC matching funds would only displace current resources. For example, State and local governments already provide secondary education for teenage AFDC recipients. The Jobs Training Partnership Act is a major source of funding for training programs. Any education and training activities that States choose to operate under GROW would be only marginal additions to their current programs.

Mr. DOWNEY. Can I also ask you with respect to poverty, is it your view and the administration that AFDC and Medicaid financing are the basic components of a poverty program and poverty is a national as opposed to a regional problem?

Mr. MILLER. We feel actually all jurisdictions share in poverty as a problem.

Mr. DOWNEY. Is it fair to assume from that statement that poverty is—you said they share in it.

Mr. MILLER. Yes. It is a national problem. It is a State problem. It is a local problem.

Mr. DOWNEY. Can I ask you if you have had an opportunity or if your staff would review a proposal that myself and Senator Evans have authored last year, and that we will reintroduce this year?

Mr. MILLER. Yes. Be glad to.

Mr. DOWNEY. It is a comprehensive welfare reform proposal where we would shift the burden of financing AFDC and Medicaid to the Federal Government, 90 percent for the Federal Government, 10 percent for the States, and pay for it by the devolving of some of the programs like EDA, UDAG, some other programs to pay for it.

If you would take a look at that we would appreciate some ideas as to whether or not the administration could support something along this line since it is our intention to be revenue neutral with respect to the proposal.

Mr. MILLER. Be glad to.

[The information follows:]

The administration's position on the bill would, of course, be highly dependent on its funding requirements over time. We encourage the committee to have CBO undertake a careful analysis of the associated Federal AFDC and Medicaid costs. We would not, however, reject outright some realignment of roles. As you know, the administration previously advanced a similar proposal, which raised concerns among many interest groups. We will watch carefully as this proposal is considered in the coming months.

Mr. DOWNEY. Let me turn your attention for a moment to the area of the customs, which is an area that concerns me as well. I would appreciate it if you could provide some rationale for the cuts that I see listed, both in the air interdiction program, which is cut from $171 million in 1987 to $86 million in 1988, and for personnel, reductions of some $30 to $40 million, and some cuts in the number of people and also a reduction of $19 million for international narcotics and also reductions in DEA.

Can you provide some basis for why in an area where it seems we want to do more in the area of customs, not less, and more in the area of drug interdiction and not less, that there are program reductions?

Mr. MILLER. I will be glad to. If you will give me a specific list of those years, I will be glad to respond to them.

[The information referred to follows:]

Subject: Customs And Other Drug Reductions

Question: Can you provide some basis for why in an area where it seems we want to do more in the area of customs, not less, and more in the area of drug interdiction and not less, that there are program reductions?

Answer: Mr. Downey, the FY 1988 Budget fully supports the Administration's emphasis on more effective drug law enforcement. In fact, actual government outlays for all Federal drug programs are increasing in every year of this Administration. In 1988, drug-related program outlays will total $3.4 billion, compared to drug outlays of $3.0 billon in 1987 and $2.2 billion in 1986.

In looking specifically at the Customs Service, the FY 1988 Budget provides another $86 million in 1988 budget authority in addition to the 1987 funding for the air interdiction program provided by the Congress. Total 1987 and 1988 spending of $257 million represents a massive increase over 1985 and 1986 levels (an average increase per year of more than 70% since 1986). One reason for the decline in 1988 budget authority for the Customs air interdiction program is that much of the funds provided by the Congress are for capital assets; once purchased, the spending need not be repeated in later years.

In addition, there are differences between the Congress and the Administration regarding the air program in two areas -- technical and policy differences. The technical differences relate to cost estimates for operating E-2C aircraft in 1987, revised Treasury estimates for costs necessary to operate three C-3I centers and additional funding made available by the Administration for more frequent operations of general support and tracking aircraft. Policy differences between the Administration and the Congress relate to the establishment of a fourth C-3I center in Oklahoma City and additional modification of tracking aircraft. The Administration believes that the Oklahoma City C-3I center would serve no useful purpose in improving air interdiction capabilities and that further modifications of tracking aircraft are not necessary for their continued performance.

As part of the FY 1988 Budget, the Administration recently submitted appropriations language to the Congress for the Customs air program to delay the obligation of approximately $32 million in no-year funds (enacted in 1987) until FY 1988. This requested reprogramming of funds will assure that the increased resources acquired in 1987 could be adequately maintained and operated in 1988. There will be, however, no Executive Branch action to defer or otherwise restrict the funds currently available until after Congressional approval of this proposal.

Regarding the Customs Service salaries and expenses account, the Administration is seeking a reduction of approximately $39 million to the 1987 enacted funding level provided by the Congress. Given previous year investments in high-technology equipment and other automated procedures, current Customs personnel can maintain highly selective inspection, examination and enforcement practices that encourage both efficiency and effectiveness, thereby negating the need for the massive staffing increases provided by the Congress. Moreover, this Budget continues to emphasize Customs drug activities, most especially the Operations Alliance effort. It should be noted that when compared to 1986 actual levels, Customs funding resources devoted towards drug activities continue to increase; in 1988, drug resources within the salaries and expenses account will total $338 million, nearly $33 million above actual 1986 resource levels.

Finally, let me respond to your assertion that the budgets for international narcotics programs and the Drug Enforcement Administration (DEA) were reduced in FY 1988. Similar to the Customs Service air interdiction example, the $19 million provided the State Department for international narcotics programs was for purchases of aircraft. This is a one-time purchase that need not be repeated in FY 1988. Also, in contrast to your assertion that the Administration is cutting the DEA budget in FY 1988, the Administration is increasing the DEA budget by $43 million above the 1987 enacted level.

Mr. MILLER. Let me just say in brief the drug enforcement issue is a very formidable one. We have a drug task force that is chaired by the Attorney General, pursuant to law, that we meet regularly about trying to orchestrate the resources from all different agencies of the Federal Government to have the greatest impact on reducing consumption.

That is what we are trying to do, reduce consumption of illicit drugs. Some of the cuts that you have pointed out probably have to do with the fact that if in one year we buy capital equipment, you don't have to buy it again the following year. But I will get you details on that.

Mr. DOWNEY. Senator D'Amato, as you know, and Senator Chiles apparently had something of a highly publicized and unpleasant confrontation with one member of the administration, and I believe Senator D'Amato said, "For God sake, get in the real world," with respect to drug cuts. Can you provide me or this committee with a little bit more of the thinking that went into the program reductions for the drug program?

Mr. MILLER. Well, the drug program in 1981 was a billion dollars. In 1986 it had grown in response to a request made by the President and responses by the Congress to a $2 billion program. The President said this is an issue that we need to have a war on. We need to devote much more attention to it. He called on individuals, friends, families, churches, schools, other institutions, to have an all out war on drugs.

He said we also need some additional Federal funding, and he proposed that a $2 billion program be increased by 50 percent to $3 billion. Then last year Congress, in response—I must admit it is kind of difficult to vote against a drug program. It kept getting escalated and escalated and became a $4 billion program.

What the President has done for this year is to go back to the $3 billion that he thinks that we can reasonably and effectively spend. Keep in mind that some of the 1987 moneys were for buying equipment and startup costs with State and local programs that need not be spent again. So that is the reason for its being at a $3 billion level.

Mr. DOWNEY. Thank you. I have one other question I would like to supply for the record if your staff would answer it as well. Thank you very much.

[The information follows:]

SUBJECT: P-3/E-2C AIRCRAFT

*Question.* It has been reported to me that you have recently authorized the release of $19 million from the Customs budget for integration of a 360-degree radar into a P-3 aircraft. I am curious as to whether you (OMB) have taken into full consideration the propriety of financing with taxpayer moneys what amounts to a research and development project for a capability already existing in the E-2C. I understand that Customs will possess two E-2C's on February 7, 1987.

Answer. Mr. Downey, in 1987, Congress included specific appropriations bill language, within the Omnibus Drug Supplemental Appropriations bill, which mandated certain funding for the modification of Customs Service P-3 aircraft with 360-degree radar. Following the passage of that bill, the Customs Service requested that these funds be available for obligation immediately. As this modification project had the potential to affect the overall Federal strategy for drug interdiction operations, I felt it fiscally prudent to postpone obligating the funds for this project (which have no-year availability) until the National Drug Policy Board (chaired by Attorney

General Meese) had assessed the technical and engineering feasability, as well as the overall cost effectiveness, of the proposed P-3 modification project. As you know, the National Drug Policy Board was created to develop and coordinate the overall Federal strategy for drug-related activities. We (OMB) expect the Drug Policy Board to make a final decision of this issue in the second quarter of fiscal year 1987 and therefore have made this funding available for obligation in the second quarter. I would note that funds for this project have been legally available for obligation since January 1, 1987, the beginning of the second quarter of fiscal year 1987.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

Dr. Miller, is the administration still in favor of reinstating the automatic trigger in Gramm-Rudman.

Mr. MILLER. Yes.

Mr. PEASE. Without qualification?

Mr. MILLER. Well, I mean if it were a trigger pulled by the wrong person, I guess we wouldn't be in favor of a trigger, but basically the concept is one that we would like to see revived.

We believe if there is a possibility of the trigger going off and shooting—it could shoot all of us in the foot.

Mr. PEASE. I agree with you on that. You made the statement in response to a previous inquiry that President Reagan is very serious about meeting the $108 billion deficit target for next year under Gramm-Rudman.

You, in your budget, estimate that your budget will reach that $108 billion.

CBO estimates it will be $135 billion. In light of the seriousness of the President about actually achieving $108 billion, would you still counsel us to use the economic assumptions and the budget figures in your budget and ignore what CBO has said?

Mr. MILLER. Yes, sir. I realize that under Gramm-Rudman-Hollings you have to respond to the CBO and also as the Budget Act is amended, respond to what CBO comes up with. We believe our assumptions are the appropriate ones, both with respect to the economic growth, inflation, interest, unemployment, et cetera, but also in terms of technically how we make these estimates of the outlays, and what to include and what not to include.

Mr. PEASE. So as our Budget Committee puts together a budget resolution for the House to consider, you would urge them to use the economic assumptions contained in your budget?

Mr. MILLER. I think, my understanding of the law is you would be required to use CBO's assumptions, and I guess I won't urge you to violate the law, but I guess I would urge CBO to use our assumptions.

We do believe our assumptions are more appropriate.

Mr. PEASE. Dr. Miller, last October when we finally got around to finishing up our work on the 1987 continuing resolution, we thought we had achieved a deficit for fiscal year 1987 of $154 billion. You put together a budget 2 months later, 2½ months later which estimates it at $173 billion for fiscal year 1987.

Can you tell me why that occurred?

Mr. MILLER. Oh, yes. First of all, Gramm-Rudman-Hollings by law, requires us to make the estimates before you have passed appropriations, using so-called Gradison rules.

Just in rough and ready figures that depressed our number about $2 billion, so we are really not looking at 144 then. We were look-

ing at the 146 if you made the estimate the way we ordinarily make it, and since then we have had about $28 billion deterioration due to technical reestimates and economic assumptions. It doesn't take a lot to give you this size difference, a decrease in revenue, an increase in costs.

Mr. PEASE. That $9 or $10 billion, was that related to slower GNP growth rate than you originally forecast?

Mr. MILLER. Yes, about that much was due to economic assumptions.

Mr. PEASE. Finally, on your recommendation for gasoline and diesel fuel taxes you are recommending that the exemption for State and local governments no longer apply; is that correct?

Mr. MILLER. Yes, sir.

Mr. PEASE. Are you at all concerned about the additional financial burden that will put particularly on local governments, especially school districts—operating school buses, for example?

Mr. MILLER. Well, it will mean some increase for them, but are we concerned? Yes. But on the other hand it is the appropriate thing to do. Anytime you take away a benefit or add a cost to anyone, anybody with any political savvy is going to say, yes, it is of a concern, but you have to make the hard choices.

Mr. PEASE. Well, in my area the only source of income for local school districts which is under their control is the local property tax. If their costs go up for school bus fuel, as they would under your proposal, they almost surely would have to consider local property tax increases.

That, to me, says while President Reagan is opposed to any tax increase, he means only at the Federal level. He is not really opposed to requiring local school districts and villages and cities and townships to increase taxes at the local level. Is that a proper distinction?

Mr. MILLER. Congressman, my grandfather was a bus driver, and I knew a little bit about this. I would be amazed if the local district had to raise taxes because of a slight increase in fuel tax applied to buses.

Mr. PEASE. It would have to increase revenue or cut back on its other expenditures, would it not?

Mr. MILLER. Sir, I postulate that the fuel tax that we are talking about is a very small proportion of the total budget of State and local jurisdictions.

Mr. PEASE. I will get some of my local school superintendents who operate school buses in rural areas to make some calculations, and let you know.

Mr. MILLER. All right, thank you.

Mr. PEASE. Thank you very much.

Mr. MILLER. Mr. Gregg.

Mr. GREGG. Thank you very much. I was wondering about your proposal to require employers to withhold FICA on the employer's share of all tips. What tax policy consideration led you to conclude that this was appropriate?

Mr. MILLER. Well, I guess it was just a matter of equity—making the employer pay tax on the amount that the employee actually receives.

It is a way of addressing an inconsistency.

Mr. GREGG. Of course, an employer can't predict tips, so it is not really equivalent to a wage situation.

Mr. MILLER. Right. Your point is well taken, they are not direct wage payments. However, employers currently report tip income of their employees to IRS. If the question is, how do you fairly assess the employer, it can be done. It is simply a matter of changing the amount of taxes paid on the tip income currently reported by the employer.

Mr. GREGG. On the general concept, as I read this, over 50 percent, about 52, 53 percent of the reductions that you are planning——

Mr. MILLER. Savings.

Mr. GREGG [continued]. Actions you are planning to get to the Gramm-Rudman target result from new revenues—call them users fees, or whatever.

Mr. MILLER. Right.

Mr. GREGG. The balance, which is less than 50 percent, of course, comes out of changes in programmatic spending?

Mr. MILLER. That is right.

Mr. GREGG. Of that, is it correct that 32 percent of the savings result from changes in health care premiums?

Mr. MILLER. Of that programmatic change?

Mr. GREGG. Right.

Mr. MILLER. Thirty-six percent comes out of medical programs in the aggregate.

As I was testifying to earlier, I don't believe it is, by and large, adversely impacting on benefits. There are cost savings.

Mr. GREGG. Basically, the President's budget is not a spending reduction document, it is a revenue-raising document. In the effort to get to the Gramm-Rudman deficit target, aren't a majority of the proposals revenue-raisers?

Mr. MILLER. That is true, especially when you count in the fact that you are depending upon current services to bring it down from 174 to 150. We have a $68 billion increase in revenue.

Again, that is very contingent upon how the economy grows—$68.1 billion increase in receipts and a $43.7 billion increase in outlays. That is the reason you have the current services deficit falling from 174 down to 150.

Mr. GREGG. On a technical point, as I understand it, the Social Security fund is now off budget, but on budget for the purposes of accounting for Gramm-Rudman. When you raise FICA taxes, you are not really reducing the general deficit, because the revenues are going into the Social Security trust fund, and, of course, Social Security is now running a fairly positive cash flow, correct?

Mr. MILLER. It is running a surplus. The deficit on the current account, minus the trust funds, is higher than the 108, but (a) I think the appropriate way to think of the deficit is to think of it in the unified budget sense.

Second, that is the way Gramm-Rudman-Hollings measures, by law.

Mr. GREGG. I can accept that on a paper basis, but on a substantive basis, it seems to me what we should be looking at is the actual general account current deficit, not at a trust fund such as social security as we try to balance the general fund.

I appreciate your being here. Thank you.

Chairman ROSTENKOWSKI. Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman.

You said earlier that reasonable people can differ on budget estimates.

Mr. MILLER. Yes.

Mr. LEVIN. I think that is acknowledged.

How far off was OMB in 1985 and 1986?

Mr. MILLER. Sir, if you will go ahead and ask your next question, in the meantime, I think I have a piece of paper that gives that information.

I will try to find it for you.

Mr. LEVIN. My next question——

Mr. MILLER. Here. I have it. Someone has handed it to me.

Mr. LEVIN. I mean the estimate you gave at this comparable time in those years compared to what it turned out to be.

Mr. MILLER. For the Fiscal Year 1982 budget, CBO estimated the deficit at $67 billion; OMB estimated it at $45 billion.

In February 1983——

Mr. LEVIN. I really wanted 1985 and 1986, what you estimated and what the deficit was.

Mr. MILLER. 1985, CBO estimated the deficit at $206 billion. We estimated $195 billion.

Mr. LEVIN. And it was?

Mr. MILLER. And that is the President's budget.

Mr. LEVIN. What was the deficit? What was it?

Mr. MILLER. It turned out to be $212 billion. That wasn't the President's budget deficit. That was the budget Congress passed, which was different.

Mr. LEVIN. So, the deficit turned out to be $17 billion more. That was in 1986, right?

Mr. MILLER. That was 1985.

Mr. LEVIN. How about in 1986?

Mr. MILLER. CBO was $186 billion. The OMB number was $180 billion.

Mr. LEVIN. The ultimate?

Mr. MILLER. The outcome was the $221 of last year. Again, that wasn't the President's budget—CBO and OMB estimates assume the Congress passed the President's budget.

Mr. LEVIN. I understand that.

So, the deficit was $41 billion larger than you estimated under the President's budget for 1986?

Mr. MILLER. The actual deficit was greater than either the CBO or OMB estimate of the deficit under the President's budget. That is right.

Mr. LEVIN. For 1987, now with revisions, your estimate versus your reestimate?

Mr. MILLER. Given the revisions in the 1987 budget, CBO estimates $174 billion in rough terms. OMB estimates $173 billion.

Mr. LEVIN. Your estimate of the President's budget when you presented it was $144?

Mr. MILLER. One hundred forty-four.

Mr. LEVIN. That is a difference of $30 billion. You didn't take into account the 10 percent give of Gramm-Rudman.

Mr. MILLER. No, we estimated $144.

Mr. LEVIN. So, that was $30 billion off?

Mr. MILLER. You are comparing apples and oranges, sir. It is the President's budget on the one hand and Congress' on the other.

Mr. LEVIN. It was different by $30 billion?

Mr. MILLER. Pardon?

Mr. LEVIN. The difference was $30 billion? The difference between your estimate under the President's budget and the ultimate figure that came out of a budget signed by the President——

Mr. MILLER. Passed by the Congress.

Mr. LEVIN [continued]. Passed by the Congress was $30 billion. So, it was 41 for 1986.

It would be in the $30 billion range for 1987.

All right. I think you can understand why there is skepticism about your present budget when you talk about that kind of a differential. Let me ask you this. If you took——

Mr. MILLER. Sir, skepticism about what?

Mr. LEVIN. Skepticism about the reality of your estimates.

Mr. MILLER. That doesn't have anything to do with the reality of our estimates. It has to do with what Congress will actually do.

Mr. LEVIN. I disagree with that. A lot of it had to do with your economic assumptions.

Mr. MILLER. The only way we can test that is if Congress would pass the President's budget.

Mr. LEVIN. It turned out your economic assumptions were wrong in those years.

Let me ask you this. If your economic assumptions for the four quarters of this fiscal year were based on the performance the first quarter of this fiscal year, what would be the deficit?

Mr. MILLER. That I don't have. I don't have that.

Mr. LEVIN. I would appreciate your supplying that.

[The information follows:]

The preliminary Department of Commerce estimate for GNP for the first quarter of fiscal year 1987 showed only a 1.7-percent annual rate of real GNP growth, and only a 1.0 percent annual rate rise in the GNP implicit price deflator. These figures will be subject to further revisions for the next several months.

The sub-par nominal GNP growth for the first fiscal quarter by itself, if not revised away, would increase the 1987 deficit by an estimated $1.4 billion with no impact on 1988 if the administration's forecast is otherwise attained. Were the preliminary sub-par growth rates of this one quarter projected through all four quarters of fiscal 1987, the deficit impact would be substantially greater, though no specific estimate has been developed for this unlikely contingency.

Mr. LEVIN. I think in each case, your economic assumptions for the full year are rosier than the reality of the first quarter.

Isn't that true?

Mr. MILLER. Rosier than what?

Mr. LEVIN. Than the reality of what happened in the first quarter?

Mr. MILLER. Well, 1984, it was just the opposite.

Mr. LEVIN. I am talking about the first quarter of this fiscal year, behind us, right?

Mr. MILLER. Yes.

Mr. LEVIN. Your assumptions for the full year are rosier than what turned out to be true for the first quarter?

Mr. MILLER. We don't know what is true. What we have is a preliminary estimate.

Mr. LEVIN. Then the preliminary estimate?

Mr. MILLER. Yes, sir. As you know, these preliminary estimates have a very wide wide dispersion. For reasons that we could talk about—trade, export increases we have had, unemployment statistics, arguably, what the leading indicators showed, and others—we have reason to believe when it is revised, it will be revised upward.

Mr. LEVIN. Quickly to change the subject to welfare reform. There is a proposal that mothers under the GROW program would be covered regardless of age of children, right?

Now it is 6 and under, and in your testimony, you say that there would be coverage for all mothers. I take it that means regardless of the age of children?

Mr. MILLER. Yes. I am told that is correct.

Mr. LEVIN. Is that realistic? Some mothers with children of 6 months would be covered by the program?

Mr. MILLER. That is what my testimony indicated. We have not sent the legislation up.

Mr. LEVIN. Thank you.

Mr. MILLER. That is being negotiated.

Mr. LEVIN. Thank you, Mr. Chairman.

Mr. MILLER. May I amend my answer on the question of the effects of the differences in the assumptions? I am informed—and I can point it out to you in the budget that the change in the economic assumptions since last year actually reduced our estimates of the 1988 deficit because of the lower interest rates.

We lost on the growth numbers, but we gained on anticipated lower inflation than we had earlier estimated.

Chairman ROSTENKOWSKI. Dr. Miller, I will allow members to submit questions to you in writing. I am sure your office will be able to answer them.

[The information follows:]

QUESTIONS SUBMITTED BY MEMBERS TO MR. MILLER AND HIS RESPONSES

*Question.* Many of the deficit reduction proposals that are in the Committee's jurisdiction are one time savings, savings from proposals that have been previously rejected by Congress or savings that undo bipartisan agreements reached last year. Overall, what proportion of the $42.4 billion in savings for FY 1988 have been previously rejected by Congress? What proportion are one time savings? What proportion are savings which alter bipartisan agreements reached in the reconciliation bill last year?

Answer. The 1988 Budget includes proposals that if adopted in total would reduce the 1988 deficit by $42 billion. Approximately 60 percent of the savings come from proposals previously rejected by the Congress. The Administration continues to believe that these proposals are well justified and should be implemented.

About 25 percent of the proposals included in the 1988 budget generate one-time savings. (Slightly more than 5 percent of the savings come from items that are both one time and reproposals.) These are primarily from physical and financial asset sales. Less than 1 percent of the total savings in the 1988 Budget result from proposals to alter provisions of the 1987 reconciliation bill. The Budget includes repeal of several expansions in the Medicare program including those for vision care and occupational therapy.

*Question.* Preliminary analysis by CBO suggests that the deficit target for FY 1988 has been exceeded by $27 to $32 billion. Have you been in touch with CBO and do you understand the reasons for this difference? What amount of the difference is due to policy changes that are embodied in your current services estimates? For example, we understand that $1.4 billion of a $5 billion estimating difference in medi-

care outlay is due to a policy change which would slow down the issuance of checks to hospitals. Is that correct?

Answer. CBO estimates that the deficit for 1988 would be $134 billion under the President's Budget, $27 billion more than the $108 billion estimated by CBO. The majority of this difference, $15 billion, is a result of differences between CBO and OMB economic assumptions. The CBO assumptions include lower real growth and higher interest and inflation rates than OMB. The remaining difference between OMB and CBO estimates of the deficit are the result of technical reestimates. OMB and CBO estimates of the President's Budget reflect the same policies. Thus, none of the $27 billion difference between the deficit estimates is a result of policy changes incorporated in OMB's current services. Differences in the assumptions about current services only affect the OMB and CBO estimates of the magnitude of cuts proposed.

Some of the difference between OMB current services and the CBO baseline for Medicare is a result of assumptions on the length of the payment cycle. However, the difference is less than $1.4 billion. In the Analysis of the President's Budget (February 1987), CBO lowered its Medicare baseline estimate slightly from its preliminary baseline largely as a result of changed assumptions on processing time for claims. CBO is better equipped to explain the specifics of its own assumptions, but the HCFA actuaries' baseline assumptions is that Medicare claims will be paid within and as close as possible to the statutory limit (reduced to 26 days in FY88). This has been Administration policy for several years and the Administration has always had the authority to pay claims as close as possible to the statutory limit. Additional FY88 claims processing savings are associated with a legislative proposal to maintain the current 30 day claims payment limitation. The CBO reestimate of the President's Budget is also based on this legislative proposal.

*Question.* What are the major risks to the economic outlook in 1987? Many private sector economists are now cutting their 1987 growth forecasts, so we appear to be looking at a situation similar to 1986 when the Administration predicted 4.0 percent real growth, but it turned out to be only 2.2 percent. If growth again fails short of your forecast, should the Gramm-Rudman target still be met?

Answer. There are at present few risk factors in the economic outlook compared to the number of positive factors. The decline in the exchange value of the dollar should strengthen U.S. exports. Lower energy costs should contribute to growth in energy-consuming sectors of the economy. Low interest rates and high stock prices have reduced the cost of capital, offsetting the one negative factor in the outlook, the short-term impact of tax reform on business investment. Inflation is very low, capacity remains ample, and labor markets are not tight, so there is no near-term threat of a need to tighten monetary policy. Moreover, the budget deficit is finally headed in the right direction, and with only moderate fiscal restraint can be significantly improved.

The Blue Chip consensus forecast of 50 private sector forecasters projected 1987 real growth at 2.9%, fourth quarter over fourth quarter, in December. In January, their average came down to 2.8%, and remained there for February. At the same time, their estimate for 1988 inched up from 3.1% to 3.2%. The Administration assumptions for 1987 and 1988 are 3.2% and 3.7%, respectively.

Growth that fell short of the Administration forecast would increase the difficulty of achieving the Gramm-Rudman-Hollings target. How much more difficult would depend on how far short from the budget assumptions growth fell. However, so long as Gramm-Rudman-Hollings remains law, endeavoring to attain the targets and proposing means to do so is a statutory obligation upon the Administration.

*Question.* The OMB spending estimate for medicare is considerably lower than the CBO baseline estimate. When compared to the Administration's current services estimates, CBO expects that $5.45 billion more will be required for medicare in FY 1988. I understand that historically the difference in baseline spending estimates only differ by $1 or $2 billion. Would you tell me why OMB believes that, under existing law, $5.45 billion less will be required for medicare?

Answer. The Administration's FY88 Medicare baseline estimate is $4.9 billion lower than CBO's estimate. (Under CBO's preliminary baseline, the difference had been $5.45 billion as your question indicated, but CBO revised its baseline down slightly in its final baseline in the Analysis of the President's Budget, so the gap has fallen to $4.9 billion (February 1987).) About $1 billion of the remaining difference results because the Medicare actuaries and CBO used different FY 1986 base data. Medicare's actuaries used FY 1986 data received from the Medicare intermediaries, which was about $1 billion lower than the Treasury data CBO used. The major difference (about $2.6 billion) results from CBO assuming faster baseline Medicare program growth than the Administration. Based on increases in total Medicare enroll-

ees, modest increases in hospital admission rates per enrollee, and modest (less than 1 percent) declines in the average length of stay, the Medicare actuaries project that hospital insurance benefits per enrollee will increase by about 7 percent a year. Seven percent growth is higher than recent experience but lower than the experience of the late 1970's and early 1980's.

*Question.* In his statement before a Senate Subcommittee last Friday, Dr. Arthur Flemming, former Secretary of Health, Education and Welfare under President Eisenhower, pointed out that in 1986, if a mother with two children was earning income equivalent to 75 percent of the poverty line, her earnings, together with AFDC and Food Stamp benefits, would lift her family above the poverty line in only eight states. Just ten years before, in 1976, the same household would have escaped poverty in 46 states. As you know, approximately one-half of female headed families with children with income below poverty work and many of them are working full-time. What assistance, if any, should the working poor receive in order to escape poverty?

Answer. Many working poor receive AFDC, as well as other public assistance. Living costs vary a lot between States; as a result a benefit level that is quite adequate in one State would be inadequate in a second and overly generous in a third. States and localities are more aware of the cost of local housing, food, utilities, and so forth, and are in a better position than the Federal government to determine appropriate levels of public assistance. The Federal role in determining the level of Federal assistance to the States for benefits for working poor is one of setting the relationship between the assistance given working poor and the assistance given those who do not work.

Chairman ROSTENKOWSKI. One last question, Dr. Miller. The President's competitiveness package mentions the R&D credit and the 861 regulations without being specific as to what is proposed. You are aware that both of these items could involve significant revenue losses which, as I understand it—are not part of the President's budget. Would you care to comment on these initiatives Dr. Miller?

Mr. MILLER. Sir, I would be fairly concerned about revenue loss in them. We haven't drafted the specifics. We are in the process of drafting.

As you know, it is quite a formidable exercise to draft all of that. I just cannot tell you at this point.

Chairman ROSTENKOWSKI. Dr. Miller, I am as concerned about revenue losses, as I am sure you are.

I hope when you put your proposal together and discuss with your staff the revenue loss implication of the 861 and R&D credit proposals that you take notice of that.

Mr. MILLER. Absolutely. We will be glad to work with you on that.

Chairman ROSTENKOWSKI. Thank you very much, Dr. Miller, for sharing your time with us.

Mr. MILLER. Thank you for the opportunity.

[Whereupon, at 1:15 p.m., the committee recessed, to reconvene at 2 p.m.]

AFTERNOON SESSION

Chairman ROSTENKOWSKI. The committee will come to order.

This afternoon, the committee will hear from Assistant Secretary of Treasury, Roger Mentz, who will provide details regarding the revenue proposals contained in the President's budget for fiscal year 1988.

We will also hear from William Maroni, the Deputy Under Secretary of Labor.

As we all know, the Gramm-Rudman-Hollings deficit target for fiscal year 1988 is $108 billion. The administration has estimated that with no changes in present law, the deficit would be $150 billion. CBO estimates an even larger deficit.

Consequently, the administration has proposed $42 billion in deficit reductions for 1988, $6.1 billion of these deficit reduction proposals are new revenues.

The vast majority of these new revenue proposals are within the jurisdiction of the Ways and Means Committee. It was extremely difficult to reduce the deficit by $10 billion for fiscal year 1987. This year, the number has increased at least four-fold. Therefore, it is more important than ever that these revenue proposals are fully understood.

Secretary Mentz, we welcome you to the committee and look forward to hearing from you. We also look forward to hearing from Secretary Maroni concerning the Labor Department proposals included in the President's budget.

Mr. Secretary, I think this is the first time you are appearing before us in the new year. I hope that we will enjoy as much camaraderie and cooperation this year as we did last year.

It is always a pleasure to have you appear and present your testimony.

## STATEMENT OF HON. J. ROGER MENTZ, ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY

Mr. MENTZ. Thank you, Mr. Chairman.

I certainly assure you I will do everything I can to keep the camaraderie the way it has been over the years. It is my pleasure to discuss the $6.1 billion of additional Government receipts shown in the President's budget proposal. It is important, I believe, that we not undo any of the dramatic and important tax reforms that were enacted last year.

Any increase in income tax rates or any new tax on the general population should be viewed as a breach of the pact reached last year to return in the form of dramatically lower rates any increase in revenue that would otherwise accrue from making the income tax base broader and fairer.

With that introduction, I will go quickly through the proposals and then, of course answer questions.

First, on extension of Medicare hospital insurance to State and local government employees. Current law requires State and local government employees hired after March 31, 1986 to be covered under Medicare. Employees hired before that are not mandatorily covered.

This proposal would require such coverage for all State and local employees. It is a large revenue pickup, $1.6 billion in fiscal year 1988, beginning January 1, 1988. So, in fiscal year 1989, the revenue pickup would be even larger.

Next is a proposal dealing with the employer's share of Social Security taxes, including all cash tips. I might say this is a proposal that has, I think, very strong conceptual merit.

The way current law presently works is that tips received by employees are considered remuneration. They are certainly subject to

income tax—no question about that—and income tax withholding and are also subject to FICA tax on the employee's portion, that is the full amount of tips up to the Social Security base.

But for employers, the full amount of tips is not subject to Social Security tax. It is only up to the amount of the minimum wage. So, if an employer is paying less than the minimum wage and the amount of tips brings it up to the minimum wage, it is only that amount equal to the minimum wage and not beyond that is subject to FICA.

This is simply a conforming change. That would put the employer portion of the tips—Mr. Pease, I must say it is a pleasure to see you—the purpose of the proposed change is simply to make the employer portion of the Social Security tax conform to the employee portion.

I think the theoretical merit of the provision is pretty clear. It is $0.2 billion in revenue that would be raised by that in Fiscal Year 1988.

There are a variety of proposals extending Social Security coverage. Those proposals are designed in part for revenue and in part to insure broader coverage. The one that is the most significant revenue item would be to extend to Armed Forces reservists, extend the FICA tax to the pay that they receive for weekend service in the Reserves.

Under current law, FICA tax applies to reservists who serve during the 2-week period that they serve in the summertime, but it does not apply to the one weekend a month that reservists presently serve.

The compensation for that can be anywhere between $1,000 and $9,000. By imposing FICA tax on that amount, it is a pickup of 0.2, $200 million in fiscal year 1988.

Students are currently not subject to FICA tax with regard to employment by a school or a college club or nonprofit organization. By including them in FICA coverage, there is a pickup of $60 million.

The other proposals, Mr. Chairman, are not really revenue proposals. They are primarily coverage.

There is an agricultural workers' proposal. Presently, agricultural employees are not subject to FICA tax unless they receive more than $150 during the year or unless they work more than 20 days. The proposal would require any employer that employs agricultural workers and pays more than $2,500 in wages to cover all his employees. It is a coverage proposal, not really a revenue proposal. It only picks up $4 million.

There is also a proposal for children between the ages of 18 and 21 who are employed by their parents. Under current law, they are not subject to FICA tax. This proposal would tax them if they were employed in their parents' trade or business.

In other words, if the parent is in a trade or business and paying wages to an employee who is his child, between 18 and 21, that would be subject to FICA under this proposal.

A similar proposal is for spouses—spouses today are excepted from the FICA tax. That would be changed where the payment is made in connection with a trade or business of the employer.

There is a proposal on group term life insurance. I am sure you all remember the income tax issue on group term life that we wrestled with on the last night of 1985's tax reform markup.

Here it is in a slightly different form. There is an inexplicable exception for all group life insurance provided as a fringe benefit to employees, even though that group life insurance benefit is subject to income tax.

The proposal would simply conform the treatment of group life insurance for FICA purposes with the income tax. That means $50,000 of insurance is exempt; beyond that, it is taxable income. It is also covered by FICA.

Other forms of fringe benefits have been similarly treated the same for FICA and income tax.

There are provisions dealing with exemptions from gasoline and other highway excise taxes. Basically, the concept here is that the highway trust fund finances Federal assistance for highways and mass transit systems. That is funded by these highway user fees, particularly excise taxes on gasoline, diesel fuel, tires, and a couple of others.

The thought is that a user fee is to provide a fund that is available to repair and maintain the highways, and that there shouldn't be any exemptions to it, and the excise tax exemptions for gasohol and certain other alcoholic fuels would be eliminated as would the exemption for state and local governments, for public bus operators, and for certain other private bus operators.

The idea here is it is a user fee. Let's get rid of the exemptions and have it apply to everyone who uses the roads. A public bus does just as much damage to roads as does my Ferrari.

I don't really have a Ferrari.

The revenue impact of that——

Chairman ROSTENKOWSKI. I am disappointed.

Mr. MENTZ. I am lucky I can maintain my 1976 Oldsmobile.

The impact of this on revenue is $0.6 billion. It is a significant proposal.

There is a proposal on the excise tax on coal production and the black lung income replacement benefit. As you know, we are all painfully aware that the black lung disability trust fund has had chronic financial problems. It is presently $2.9 billion in debt, even though the Federal Government assumes responsibility for paying a billion dollars a year in income replacement benefits to beneficiaries and also pays the interest on the amounts borrowed by the trust fund.

The proposal is to increase the excise tax on the sale of coal by producers from $1.10 per ton for coal mined from underground mines to $1.70; from 55 cents to 85 cents per ton on coal mined from strip mines.

Also, the administration proposed to repeal the requirement that the general fund bear the interest costs incurred by the trust fund and would propose that black lung replacement benefits be included in taxable income.

The revenue impact of the excise tax increase is $0.3 billion, and the black lung replacement proposal is $21 million.

There is a proposal on the rail industry pension fund. It is financed primarily by payroll taxes. There are two tiers of benefits:

tier 1 and tier 2. The railroad fund is basically not adequately funded at the moment. The recommendation is to increase the tier two-level tax and also subject railroad employees to Federal-State unemployment insurance.

The increase in tax proposed on the tier 2 is an increase of 1.5 percentage points effective January 1, 1988, and 1.5 effective January 1, 1989. That is split between the employer and the employee.

The revenue there is $0.1 billion for fiscal 1988 for the increase in tax and $0.1 billion for covering the employees in the unemployment insurance system.

The administration proposes to repeal the windfall profit tax. The windfall profit tax, as you know, is an excise tax imposed on domestically produced crude oil classified in three separate tiers.

It was enacted in 1980 when there was a dramatic increase in the price of domestic crude due to decontrol of oil, and while the price did go up significantly at that time, as we all know, it is dramatically down now.

In fact, it is down below the pre-control levels adjusted for inflation. We are collecting virtually no windfall profit tax right now, but administering the tax is a headache and a burden, both for the people subject to the tax and the Internal Revenue Service.

Our projections are that there is no meaningful amount of revenue oil price that will be raised by the windfall profit tax under the OMB assumptions, and, therefore, we would propose that it be repealed.

We would expect no revenue impact based on OMB forecasts for that proposal.

There is a proposal revising the customs user fees. As you recall, last year, Congress enacted an added value or end-user fee on imports. That fee does not apply to imports that contained U.S.-produced components.

The proposal is for the Secretary of the Treasury to prescribe and collect fees that are consistent with what it costs the Customs Department to maintain its service and to extend the fee indefinitely—it would have expired, I believe, in 1989—and also to have the fee be imposed on all imports, including those with U.S. components.

There is a proposal involving the Bureau of Alcohol, Tobacco and Fire Arms. While there are excise taxes—of course, significant excise taxes—on alcohol, tobacco, and fire arms, there is presently no fee or user fee on alcohol, tobacco and fire arms businesses, and there is a view that the costs incurred in monitoring compliance with Federal law could be compensated for by a user fee. So there is a proposal that a fee be imposed—for example, for licensing and permit fees for certain manufacturers, dealers, and importers of fire arms, ammunitions, and explosives.

Similar fees would apply to producers, retailers, and manufacturers of alcohol and tobacco. These are not retail consumer taxes, but they are fees imposed upon people in the production chain.

We would expect that that could raise about $50 million.

There is a proposal to increase Internal Revenue Service funding that would involve an appropriation of $624 million for fiscal year 1988. That would produce revenue anticipated of $2.4 billion.

My understanding is that Commissioner Gibbs will be testifying on that subject at a later time.

There are a couple of other miscellaneous provisions which I would propose to skip over.

That concludes my prepared remarks. I would be pleased to answer questions.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary.

[The statement of J. Roger Mentz follows:]

Release Upon Delivery
Expected at 2:00 P.M., E.D.T.
February 3, 1987

STATEMENT OF
J. ROGER MENTZ
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

It is my pleasure to be here today to discuss certain revenue initiatives included in the President's fiscal year 1988 budget proposal. I will address in particular the $6.1 billion of additional "governmental receipts" shown in the President's budget proposal.

It is extremely important that we not undo any of the dramatic and important tax reforms that were accomplished last year. Any increase in income tax rates or any new tax on the general population should be viewed as a breach of the pact reached last year to return, in the form of dramatically lower tax rates, any increase in revenue that would otherwise accrue from making the income tax base broader and fairer.

With this in mind, the President has proposed revenue initiatives in his budget for fiscal year 1988 that fall into three broad categories: first, collecting taxes owed but not paid; second, making certain trust fund reforms; and third, charging reasonable user fees for Federal programs that deliver services to identifiable beneficiaries. None of these initiatives constitutes a general tax increase for the American taxpayer. Rather, the proposals represent a strengthening of our present system and the elimination of certain unwarranted exceptions under current law.

I will discuss each of the revenue initiatives in turn, except for the proposal to increase Pension Benefit Guaranty Corporation premiums for employers. Another Administration representative will discuss this proposal.

## Extend Medicare Hospital Insurance Coverage to all State and Local Government Employees

### Background

State and local government employees who began work after March 31, 1986 are covered by Medicare Hospital Insurance, and a tax is imposed on both the employee and the employer to pay for this benefit. The rate of tax for 1987 is 2.9 percent of the employee's wages (up to $43,800), paid half by the employer and

half by the employee. An employment tax for Medicare is not imposed, however, on the wages of State and local government employees who were hired before April 1, 1986.1/ Nonetheless, roughly 75 percent of such employees receive Medicare coverage because of eligibility through a spouse or because of a prior period of work in covered employment. Medicare coverage is mandatory for Federal employees, regardless of when hired.

Proposal

The Administration proposes to extend Medicare coverage to State and local government workers hired before April 1, 1986.

Discussion

Extension of Medicare coverage to State and local government employees hired before April 1, 1986, who are the only major group of employees in the United States not participating fully in Medicare, would ensure that the 25 percent of such employees who are not currently covered receive the benefits of Medicare. Such a change also would eliminate the charge to the Medicare trust fund caused by the fact that most State and local employees, even though they are not subject to the payroll tax, are nevertheless covered by Medicare.

Revenue Impact

We estimate that this change in Medicare coverage, proposed to be effective January 1, 1988, will increase receipts by $1.6 billion in the 1988 fiscal year.

## Expand Employer's Share of Social Security Taxes to Include All Cash Tips

Background

Under Chapter 21 of the Internal Revenue Code of 1986 ("Code"), relating to Federal Insurance Contribution Act ("FICA") taxes used to fund the Social Security system, a tax is imposed on the employee and the employer, based on the wages paid to the employee. In general, the tax imposed on the employee and the employer is equal. The employer is responsible for withholding the employee's share of the tax from the employee's wages and remitting the tax, together with the employer's share of the tax, to the Internal Revenue Service. The current tax rate for both the employer and the employee is 7.15 percent of wages, consisting of 5.7 percent for Old-Age, Survivors and Disability Insurance and 1.45 percent for Medicare Hospital Insurance.

Section 3121(q) of the Code provides that for purposes of chapter 21 of the Code, other than the tax imposed on employers, tips received by employees are considered remuneration for services and are subject to the FICA tax imposed on employees. The tips are generally deemed to be received at the time the employee files a written statement with the employer reporting the receipt of the tips, as is required under section 6053 of the Code.

The full amount of tips received by an employee is not, however, usually subject to the FICA tax imposed on the employer. Under section 3121(t) of the Code, if an employer pays an

1/States and localities are authorized to extend Medicare coverage to employees hired before April 1, 1986, if they enter into a voluntary agreement with the Department of Health and Human Services.

employee wages that are below the Federal minimum wage, and the employee also receives tips in the course of his or her employment, the employee is deemed to receive wages equal to the Federal minimum wage for purposes of the employer's share of FICA taxes. Any tips received in excess of the difference between the wages paid and the minimum wage, however, are not subject to the employer's portion of the tax.

To illustrate the effect of this rule, assume that an employee earns $6.25 an hour as a waiter, consisting of $2.25 an hour in wages and $4.00 an hour in tips. The employee is required to pay social security tax on the full $6.25 an hour, subject to the applicable wage base limitation. The employer is only required to pay the tax on the Federal minimum wage, currently $3.35 an hour, rather than the full $6.25 an hour.

Proposal

The Administration proposes that all cash tips be included within the definition of wages for purposes of the employer's share of FICA taxes. Thus, employers would be required to pay FICA taxes on the total amount of cash tips (but, obviously, not in excess of the Social Security wage base).

Discussion

Requiring the employer to pay FICA taxes on the same amount of wages as does the employee--salary plus tips--follows the general structure of Chapter 21 that requires an equal tax to be paid by both parties. This proposal would thus eliminate the advantage currently enjoyed by some employers (those whose employees receive a portion of their wages by means of tips) and not by other employers.

In addition, employees under present law earn Social Security credit for the full amount of tips received, while the employer's share of FICA taxes is usually based on a smaller amount. In effect, the Social Security trust fund is subsidizing the employer to the extent of the employer's share of FICA taxes on any tips received by an employee in excess of the difference between the employee's wages and the Federal minimum wage. The fact that the employer does not directly pay the tips to the employee should not excuse the employer from payment of its share of FICA taxes. In substance, tips received by employees are the economic equivalent of wages and should be taxed in the same manner.

Present law regarding tips also creates an administrative burden for the Social Security Administration ("SSA") because separate records must be kept of the amount of reported tips for tax accountability purposes. Each year the U.S. Treasury transfers to the Social Security trust fund the amount of FICA taxes due on the total wages reported to the SSA during the prior year. Because no FICA taxes are paid by the employer on tips (other than the amount necessary to bring the employee's salary up to the minimum wage), the SSA must keep a separate record of tips so that it will be able to tell the Treasury Department the total amount of wages on which both employer and employee taxes are due and the total amount on which only employee taxes are due.

Revenue Impact

We estimate that the inclusion of the full amount of cash tips in the definition of wages for all purposes, proposed to be effective January 1, 1988, will increase receipts in the 1988 fiscal year by $0.2 billion.

## Extend Social Security Coverage to the Inactive Duty Earnings of Armed Force Reservists and to Earnings of Certain Students, Agricultural Workers, Individuals Aged 18-21 who Work for their Parents, and Individuals who Work for their Spouses

### Background

Social Security taxes are imposed on the "wages" of an employee received as remuneration for "employment," both terms being defined in section 3121 of the Code. An employee only receives Social Security credit for his earnings if his salary constitutes wages under section 3121 and if his job is included in the definition of employment ("covered employment").

Armed Forces Reservists. Approximately 1.4 million Armed Forces reservists do not receive Social Security credit and are not subject to Social Security taxes for their inactive duty earnings, because "inactive duty training" (generally, weekend training drill sessions) has not been included as covered employment under section 3121. Earnings from full time active duty or from "active duty for training" (training sessions lasting several weeks) constitute covered employment under current law.

Students. Services performed by a student under various circumstances in an academic setting are excluded from coverage under Social Security and the student's wages are not subject to FICA taxes. Such students include those employed by a school they are attending (or college club or an auxiliary nonprofit organization of a school) and student nurses employed by a hospital or nurses' training school they are attending.

Agricultural Workers. Under present law, cash remuneration paid to an employee in any taxable year for agricultural labor is excluded from the definition of wages unless the employee receives more than $150 during the year for such labor or the employee works for the employer more than 20 days during the year.

Individuals Aged 18-21. Services performed by individuals under age 21 who are employed by their parents, even if employed in the parent's trade or business, do not currently constitute covered employment.

Spouses. Services performed by an individual in the employ of his spouse do not constitute covered employment.

### Proposal

The Administration proposes to include services performed by reservists in "inactive duty training," by students employed by their educational institution, by individuals aged 18-21 working for their parents in a trade or business and by individuals working for their spouses in a trade or business, in the definition of covered employment. The Administration also proposes, with respect to agricultural labor, that: (a) any remuneration for agricultural labor paid by an employer to an employee constitute wages if the employer pays more than $2,500 to all employees for such labor during the taxable year, (b) the $150 annual cash pay test continue to be applied if the $2,500 annual payroll test is not met, and (c) the 20-day test be eliminated.

### Discussion

Armed Forces Reservists. The proposal to include inactive

duty training, commonly called monthly drill training, within the definition of covered employment would improve Social Security protection for reservists. Such training was not originally included in the definition of covered employment for two reasons: (1) because most reservists were covered under Social Security through their regular work, coverage of monthly drill training, which involved very small amounts of pay, would have resulted in little additional Social Security protection for reservists; and (2) reporting pay for monthly drill training would have imposed an undue administrative burden on reserve units.

These reasons for not covering inactive duty training are no longer compelling. The pay for a monthly drill training is now substantial. Such drill pay accounts for approximately 70 percent of a reservist's annual reserve earnings. Generally, a reservist is required to train at least one weekend monthly. Drill pay ranges from approximately $1,000 to $3,800 a year for enlisted members and from $1,700 to $9,000 for officers.

The proposal would not create an administrative burden for reserve units, because they now withhold Federal income taxes from wages paid to reservists for all services, including inactive duty training. Indeed, because reservists' pay would be treated the same for Social Security and Federal income tax purposes, the proposal would reduce reporting complexities.

Students. The reason for excluding certain student services from the definition of covered employment was that the small amount of protection students would gain would not be proportionate to the wage reporting and tax payment burden imposed on their employers. However, because in most instances the employer is now required to withhold income taxes from such earnings and because payroll practices have become more sophisticated, the administrative burden placed on employers by the proposal is not unreasonable.

Furthermore, students employed by their educational institutions need the protection of the Social Security program as much as other workers. Because of this exclusion, students may not gain any Social Security protection or may have gaps in their protection. This is important because features have been added to Social Security that are particularly desirable for younger workers (e.g., disability benefits and Medicare for the disabled). Finally, changes in the student population itself have increased the students' need for protection--students today are older, stay in school longer and are more likely to be married and have children.

Agricultural Workers. The proposal to adopt an annual $2,500 threshold test for agricultural employers would result in the coverage of more than 95 percent of the remuneration paid to all farm workers and would improve the Social Security protection afforded to about three-quarters of a million farm workers and their dependents. The proposal will not unreasonably increase the recordkeeping burden of farm employers. In particular, farms with expenditures in excess of $2,500 for farm wages will in all likelihood already report wages for Social Security purposes for at least some employees who meet the coverage test under current law. These employees will thus already be familiar with Social Security tax recordkeeping. The 20-day test would be eliminated under the proposal because, due to increased wage levels for farm work, employees will normally meet the $150 test well before working for 20 days.

Individuals Aged 18-21. Individuals between the ages of 18 and 21 who are employed by their parents cannot acquire the Social Security coverage which is available to other employees the same age who perform the same or similar services for

employers other than their parents. Changing the law to provide coverage for an individual aged 18 or older employed in his parent's business also would eliminate a potential tax avoidance device whereby self-employed persons may be able to use the present coverage exclusion to reduce their own Social Security taxes. Under present law, the self-employed person can take the position that paying a child under age 21 a large salary, which is not subject to the Social Security tax, and claiming the salary as a business deduction, will thereby reduce the amount of the parent's income that is subject to the Social Security self-employment tax.

Spouses. Under current law, an employee spouse is not covered under Social Security in the same manner as other employees. The employee spouse, even one who has some prior earnings from covered employment, may not have disability protection and will have reduced retirement protection. More significantly, in cases where the employee spouse had no prior earnings from covered work, he will have no Social Security protection in his own right. Accordingly, if the spouses were to divorce within ten years of marriage, the employee spouse would lose eligibility for Social Security auxiliary or survivor benefits and would have no protection despite years of employment. The Administration's proposal would provide a married person who is actually performing services and being paid wages as an employee of his spouse with protection under the Social Security system.

The exclusion for an employed spouse also lends itself to a tax avoidance device, similar to that described above for children, under which a married couple working together in a business may attempt to reduce their Social Security tax liability by paying a large salary to the employed spouse, thereby lowering the amount of self-employment income taxable and creditable to the other spouse. The proposal to repeal the exclusion for such wages removes this potential artificially to lower FICA tax payments when a couple operates a business together.

Revenue Impact

The changes in Social Security coverage described above, proposed to be effective January 1, 1988, are estimated to increase receipts by $0.2 billion in FY 1988.

## Treat Employer-Provided Group-Term Life Insurance as Wages for Purposes of Social Security Taxes

Background

The value of group-term life insurance coverage provided to an employee is excluded from the definition of "wages" in section 3121 of the Code. For income tax purposes, however, the value of such insurance, other than the cost of the first $50,000 of coverage provided to an employee, is included in taxable income. Moreover, if the insurance coverage is provided to employees in a manner that discriminates in favor of key employees, then the entire cost of the coverage is included in taxable income of the key employees.

Proposal

The Administration proposes to conform the treatment of group-term life insurance for Social Security tax purposes to its treatment under the income tax. Accordingly, the cost of group-term life insurance would be included in the definition of

wages for purposes of FICA taxes if the cost were taxable to the employee.

Discussion

The proposal would treat the provision of group-term life insurance the same for both FICA and income tax purposes. There is no Social Security program rationale for the unlimited exclusion of this employee fringe benefit. The FICA tax status of certain other fringe benefits, such as group legal services, meals and lodging, educational assistance, and dependent care assistance, has similarly been tied to the income tax status of such benefits.

Revenue Impact

We estimate that the inclusion of certain group-term life insurance in the definition of wages, proposed to be effective January 1, 1988, will increase revenue by $43 million in fiscal year 1988.

## Repeal Certain Exemptions from Gasoline and Other Highway Excise Taxes

Background

The Highway Trust Fund, which is used to finance Federal assistance for highways and for mass transit systems, is funded by highway user fees, including excise taxes on gasoline, diesel fuel and tires, a sales tax on heavy trucks and trailers, and a heavy truck highway use tax.

Although the Highway Trust Fund is intended to be funded by all who use the nation's highways, there are several exceptions to this general rule. In particular, gasohol and certain other alcohol fuels, as described below, are partially exempt from the excise taxes on gasoline and diesel fuel. State and local governments are fully exempt from all Federal highway excise taxes. Public bus operators are fully exempted from Federal gasoline, diesel fuel, and other highway excise taxes. Private bus operators are fully exempt from the excise tax on tires and are partially or fully exempt from certain other excise taxes.

Proposal

The Administration proposes to repeal the exemptions from the highway excise taxes described above.

Discussion

Alcohol Fuels. Under current law, the general tax rate is 15 cents per gallon for diesel fuel and 9 cents per gallon for gasoline and special motor fuels. An exemption of 6 cents per gallon is provided for gasohol and certain alcohol fuels (neat methanol and ethanol fuels that contains 85 percent or more alcohol) produced from a substance other than petroleum or natural gas, and an exemption of 4 1/2 cents per gallon is available for such alcohol fuels produced from natural gas. The exemption of gasohol and alcohol fuels from the excise taxes for highway use distorts the allocation of resources. It also encourages users to purchase fuels that have a higher economic cost than the alternative fuels because the tax system lowers the cost of the subsidized fuel. Moreover, the exemptions allow users of the highways to escape paying their fair share of the applicable use taxes. Accordingly, the Administration proposes to repeal these excise tax exemptions. (The Administration does

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not propose that the alcohol fuel tax credit, described in section 40 of the Code, be repealed).

Bus Operators, State and Local Governments. Highway Trust Fund taxes are designed to charge users of the public highways for the wear and tear they cause and for the Federally funded highway improvements made for their benefit. The exemptions for bus operators and for State and local governments are inconsistent with having all highway users paying their fair share of the cost of maintaining and improving our highway system.

Revenue Impact

We estimate that the repeal of these special exemptions, proposed to be effective October 1, 1987, will increase receipts by $0.6 billion in FY 1988.

## Increase Excise Tax on Coal Production; Treat Black Lung Income Replacement Benefits as Taxable Income

Background

The Black Lung Disability Trust Fund, which provides benefits to individuals (and their survivors) disabled by pneumoneucleosis (black lung disease), is funded in part by an excise tax on the sale of coal by producers. The current rate of tax is $1.10 per ton for coal from underground mines and $.55 per ton for coal from surface mines, with a cap of 4.4 percent of the sales price for each ton of coal produced. The Trust Fund is presently $2.9 billion in debt, even though the Federal government has assumed responsibility through the General Fund for paying $1 billion a year in income replacement benefits for some miners, whose benefits are distributed by the Social Security Administration from general revenues, and the General Fund is currently bearing the interest costs on the amounts the Trust Fund has borrowed.

Under section 104(a)(1) of the Code, black lung replacement income benefits are excluded from taxable income.

Proposal

The Administration proposes to increase the excise tax on the sale of coal by producers to $1.70 per ton for coal from underground mines and $.85 per ton for coal from surface mines, subject to a cap of 6.8 percent of the sales price. This rate would apply through 1990, with decreasing rates thereafter. The Administration also proposes to repeal the requirement that the General Fund bear the interest costs incurred by the Trust Fund, and proposes that black lung replacement income benefits be included in taxable income.

Discussion

The excise tax proposed by the Administration is necessary to reduce and eventually to eliminate the deficit in the Trust Fund. The Administration's 1988 budget proposes certain changes to slow the growth of black lung benefit payments, including a one-year freeze on cost-of-living adjustments for benefits. Because benefit changes alone will not permit retirement of the Trust Fund's indebtedness, however, the excise tax on coal must be increased to restore the Trust Fund to solvency.

The exclusion of black lung income replacement benefits from taxable income is inappropriate because it allows income that is merely replacing taxable income to escape tax.

Revenue Impact

The increased tax on coal production and sale, proposed to be effective October 1, 1987, will increase FY 1988 receipts by $0.3 billion. The inclusion of the black lung replacement income benefits in income, proposed to be effective January 1, 1988, will increase FY 1988 receipts by $21 million.

## Increase Contributions to the Rail Industry Pension Fund; Extend Federal Unemployment Tax to Railroad Employment

Background

The rail industry pension fund is financed primarily by payroll taxes imposed on covered employers and their employees. Under present law, both the employer and the employee pay a "Tier I" tax that is equivalent to the Social Security taxes. In addition, a Tier II tax is paid by both the employer and the employee. The current rate of the Tier II tax is 14.75 percent for employers and 4.25 percent for employees, computed on the first $32,700 of the employee's salary.

Railroad employment is not presently covered by the Federal-State unemployment insurance system. Railroad employees are covered by a separate Railroad Sickness and Unemployment Fund, which is financed by payroll taxes levied on rail employers. The Fund has been insolvent for 22 of the last 27 years. It currently owes approximately $800 million to the rail pension fund.

Proposal

The Administration proposes to increase railroad retirement Tier II taxes by a total of 1.5 percentage points effective January 1, 1988, and by an additional 1.5 percentage points effective January 1, 1989. This increase will be shared by the employer and the employee. Railroad workers would become covered under the Federal-State unemployment insurance system beginning with transitional coverage on October 1, 1987. Railroads would begin paying taxes under the Federal Unemployment Tax Act effective January 1, 1988.

Discussion

Financing legislation for the rail industry pension fund enacted in 1974, 1981, and 1983 was based on certain assumptions as to the level of railroad employment and the level of pension contributions necessary to keep the Fund solvent. Those assumptions have proven to be incorrect and an increase in rail pension contributions, as recommended by rail pension actuaries, is needed in order to ensure the solvency of the Fund. Bringing rail employees within the Federal-State unemployment insurance system would result in these employees receiving the same unemployment insurance benefits as do other employees. This proposal would repay the $800 million debt to the rail pension fund.

Revenue Impact

We estimate that the additional pension fund contributions, proposed to be effective January 1, 1988, and again on January 1, 1989, will increase receipts by $0.1 billion in 1988 and $0.3 billion in 1989. We estimate that coverage of rail employees under the Federal-State unemployment insurance system, beginning with transitional coverage on October 1, 1987, will increase

receipts by $0.1 billion in 1988.

## Repeal the Windfall Profit Tax

### Background

Under current law, an excise tax is imposed on domestically produced crude oil. Taxable crude oil is classified in three tiers. Generally, oil in tier one is "old" oil that had been subject to price controls; oil in tier two consists of oil produced by a stripper well, plus petroleum reserve oil; and oil in tier three is newly discovered oil, tertiary oil and heavy oil. The base for the tax is the difference between a statutory base price (lower for tier one oil and progressively higher for tiers two and three), adjusted for inflation, and the amount for which oil is sold, less a severance tax adjustment. The tax rate is 70 percent for tier one oil, 60 percent for tier two oil, and 30 percent for tertiary oil and heavy oil. The tax rate for newly discovered oil is 22-1/2 percent through 1987, 20 percent for 1988 and 15 percent for 1989 and thereafter. Independent oil producers are taxed at a 50 percent rate for tier one oil with respect to 1,000 barrels per day of production and are exempt from the windfall profit tax on stripper well oil.

The windfall profit tax is scheduled to phase out over a 33-month period beginning in January 1991, or the first month after December 1987 in which cumulative net receipts exceed $227.3 billion, whichever date occurs first.

### Proposal

The Administration proposes to repeal the windfall profit tax.

### Discussion

The windfall profit tax was enacted in 1980 when a dramatic increase in the price of domestic crude oil was expected due to the decontrol of that price. Although the price of domestic oil did initially reach record highs, in recent months the price of oil has dropped so much that it is now below its pre-decontrol level (when adjusted for inflation). Consequently, little or no windfall profit tax is being collected, and the tax itself is, therefore, no longer appropriate. Even if crude oil prices again rise to levels that would generate significant profits for domestic oil producers, such profits would, in no way, be considered "windfall" profits. This is because a return to a profitable situation for domestic oil producers would be the result solely of market conditions (here and abroad) and not the result of the government lifting an artificial price barrier, as was the case when the tax was first imposed.

In general, the Tax Reform Act of 1986 was designed to produce uniform rates of taxation on the income generated in different activities, and to eliminate tax-induced distortions in investment. Repeal of the windfall profit tax is consistent with that objective.

### Revenue Impact

Under the Administration's current oil price projections, the repeal of the Windfall Profit Tax would not have any revenue impact in 1988, or at any time prior to 1991.

## Revise Customs Users Fee

### Background

In 1986, Congress enacted an ad valorem users fee on imports. The rate of the fee is 0.22 percent of value in 1987, dropping to 0.17 percent in 1988. For 1989, the Secretary of the Treasury is authorized to reduce the fee so that the amount realized is equal to the amount necessary for salaries and expenses for the commercial operations of the Customs Service. The fee is scheduled to expire on September 30, 1989. The reason for enacting this fee was to ensure that the costs of services provided by the U.S. Customs Service are borne by the users of those services and not by the general taxpayer. Accordingly, the proceeds of the fee are deposited into a dedicated Customs Service account and are used exclusively for the funding of Customs costs in processing all commercial imports.

Particular goods, including those imported under Schedule 8 of the Tariff Schedules (which includes products containing U.S. components--item 807.000 in the Schedules), are exempt from the fee.

### Proposal

The Administration proposes to provide the Secretary of the Treasury the authority to prescribe and collect fees, on a transaction cost rather than ad valorem basis, for the provision of any Customs service performed in connection with the processing of any merchandise that is entered into the United States or admitted to a foreign trade zone, or withdrawn from a warehouse, foreign trade zone, or other bonded status. These fees would apply indefinitely. In addition, the Administration proposes that the revised user fee will apply to all imports as determined by the Secretary of the Treasury, after consultation with the heads of other departments.

### Discussion

The application and extension of the user fee to all imports entering the country is consistent with the concept that those who benefit from specialized government services should pay for them directly. Last year, Congress took the first important step by imposing an ad valorem fee, and the Administration now proposes the enactment of authority to permit the full recovery of Customs costs incurred while processing cargo.

### Revenue Impact

The elimination of the exception for the goods listed in Schedule 8, proposed to be effective on July 1, 1987, is estimated to increase receipts by $0.1 billion in the 1988 fiscal year.

## Extend the Airport and Airway Trust Fund Excise Taxes

### Background

The Airport and Airway Trust Fund provides money for airport construction, facilities and equipment for the air traffic control system, research and development, and Federal Aviation Administration operating expenses. The Trust Fund is financed by a variety of user fees, including excise taxes on airline fares,

aviation fuel, and air shipments. These user fees are scheduled to expire on December 31, 1987.

Proposal

The Administration proposes to extend existing airport and airway user fees for an additional two-year period.

Discussion

Consistent with its position that the users of Federal services should help pay for such services, the Administration believes that the Airport and Airway Trust Fund should continue to be funded by means of user fees such as the excise taxes described above.

Revenue Impact

The revenues from the extension of the user fees described above is not reflected in the $6.1 billion of new revenues shown in the Administration's budget proposal because it is an extension of an existing tax.

## Impose User Fees for the Bureau of Alcohol, Tobacco, and Firearms

Background

A variety of excise taxes are currently imposed on alcohol and tobacco products and firearms. Present law does not specifically impose fees on alcohol, tobacco or firearm businesses, however, to compensate for the costs incurred in monitoring compliance with Federal law.

Proposal

The Administration proposes that user fees, primarily in the form of licensing and permit fees, be paid by individuals and firms who make use of the services provided by the Bureau of Alcohol, Tobacco and Firearms ("BATF").

Discussion

As with other user fees proposed in the Administration's 1988 budget, the user fees proposed for the BATF would require those persons making use of the specialized services of the government, in this case those provided by the BATF, to help pay for such services. Such fees would include, for example, licensing and permit fees for certain manufacturers, dealers and importers of firearms, ammunition and explosives; and similar fees for certain producers, processors and retailers of alcohol and tobacco. In addition to licensing and permit fees, the BATF would charge special fees to help recoup the costs associated with certain unique services provided to the alcoholic beverage and tobacco industries such as fees for laboratory analysis and certification.

Revenue Impact

We estimate that the proposed BATF user fees will increase 1988 receipts by $50 million.

## Increase Internal Revenue Service Funding

### Background

As a result of the Tax Reform Act of 1986, it is easier for taxpayers to pay the correct amount of taxes and for the Internal Revenue Service ("IRS") to determine how much each taxpayer owes. Nevertheless, a large gap still exists between the amount of taxes owed and the amount paid.

### Proposal

The Administration proposes to increase IRS funding for the 1988 fiscal year.

### Discussion

Increased IRS funding for the 1988 fiscal year will ensure the smooth implementation of tax reform, will improve enforcement of the tax laws, and will help close the gap between taxes owed and taxes paid.

### Revenue Impact

We estimate that the proposed increases in IRS funding will increase receipts in the 1988 fiscal year by $2.4 billion.

## Miscellaneous Provisions

Other revenue initiatives contained in the President's budget proposal, not discussed above, include user fees charged by the Internal Revenue Service including fees for the issuance of private letter rulings and determination letters ($60 million); increases in Nuclear Regulatory Commission fees ($73 million); initiation of Federal marine fishing license and other fees for commercial and recreational fishing ($46 million); initiation of rail sector financing of a portion of windfall benefits ($92 million); increases in the contributions of the District of Columbia and its employee to civil service retirement ($10 million); and initiation of fees for the United States Travel and Tourism Administration on ("USTTA") resulting in $10 million in receipts for the Treasury and $9 million of offsetting collections for USTTA.

* * *

This concludes my prepared remarks. I would be pleased to respond to any questions.

Chairman ROSTENKOWSKI. We will hear next from Mr. Maroni.

**STATEMENT OF HON. WILLIAM J. MARONI, DEPUTY UNDER SECRETARY FOR CONGRESSIONAL AFFAIRS, U.S. DEPARTMENT OF LABOR, ACCOMPANIED BY TOM KOMAREK, ASSISTANT SECRETARY FOR ADMINISTRATION, MANAGEMENT, AND BUDGET**

Mr. MARONI. I would like to touch on a couple of the legislative items contained in my statement that are of interest to the Ways and Means Committee.

We embarked on a new project at the start of this year called Work Force 2,000. In basic terms, very broad terms, set by the Secretary, our objectives are to anticipate and prepare for change by enhancing the skills of the work force and using the Nation's pension system.

As part of that Work Force 2,000 study, we have a number of initiatives, some of which are contained in our budget this year that are at different stages of development.

In fact, we were even meeting as late as this morning on several of these policy issues. I can, however, discuss some of the outlines of these provisions.

In the next week to 10 days, we anticipate meeting with the staff of this committee as well as the Labor Committees to outline in greater detail what these provisions will be.

I should also say that three or four of these provisions will be contained in a competitiveness package to be presented by the administration and discussed with committees on the hill in working toward a bipartisan competitiveness proposal.

The first initiative is the new worker adjustment assistance program. We are proposing to replace the current Job Training Partnership Act, dislocated worker program, known as title III, and the trade adjustment assistance program with a single integrated program of counseling, job search, basic education, literacy and skill training.

The proposal we hope to work out will be based on six principles laid out by Secretary Brock: eligibility for dislocated workers, for all dislocated workers, regardless of the cause of their dislocation; close linkage to the unemployment insurance system; early intervention and quick response; better targeting of funds to areas that need it; emphasis on training and reemployment as opposed to income support; facilitating State labor management and community cooperation in responding to dislocation; and finally, an emphasis on a variety of approaches and flexibility to help different kinds of dislocated workers meet different kinds of needs at the State and local level.

The program would be funded at $980 million and is expected to serve an estimated 700,000 workers annually. That $980 million level is over $600 million over our current budget authority for JTPA and the trade adjustment assistance program.

The proposal that we hope to work out with the appropriate committees will build upon the lessons that we have learned from JTPA and trade adjustment assistance.

We have found that the most successful dislocated worker programs are those where services to affected workers are available

early in the layoff cycle and where employers and workers can be involved in the design of the program and design of the delivery.

Our proposal will encourage voluntary, advance notification of plant closings and mass layoffs and make available to officials early intervention assistance in the form of in-plant assistance, labor management cooperation, and other incentives.

Second, the second initiative will deal with the problems of youth unemployment and welfare dependency. Our aid to families with dependent children, the AFDC youth program, would be authorized as an amendment to the Job Training Partnership Act and will be designed to revamp the current summer youth program.

We would allow local officials the option of funding the program on a year-round basis with training education support services for youth and AFDC families or on a similar basis.

The budget request for this initiative is $800 million, which is $50 million over the currently enacted budget authority for the summer youth program.

We have chosen to target welfare youth for a number of reasons. We think those should be noted here.

AFDC youth, young parents, and the children of AFDC-dependent parents experience a number of barriers to unemployment.

In fact, 75 percent of these individuals are located in the inner city.

Other legislative initiatives mentioned in my statement deal with changes to the employment services as well as the unemployment insurance programs to give States greater freedom of action in constructing comprehensive approaches.

We will be consulting with this committee and the Labor Committees on these two proposals in the next week.

Other initiatives in our legislative agenda and budget this year has been touched on by Mr. Mentz.

The black lung changes—I would only mention here that our estimates are that the current indebtedness will begin to grow after the expiration of the interest forgiveness period in 1991, and our estimates are that it will exceed $13 billion by the end of fiscal year 2010.

Finally, there are two pension proposals that are contained in our agenda this year. One deals with improvements to the declining financial status of the Pension Benefit Guarantee Corporation, the PBGC.

The second is a separate comprehensive pension termination and funding proposal. I think it is important to view these as two very separate proposals.

The first deals with adequate funding for the PBGC. In order to maintain the solvency of the revolving fund of the PBGC, we will be proposing a variable rate premium. With respect to the funding proposal, I would mention there were a couple of news reports on it in the New York Times today and the Washington Post, I simply would say that the proposal is still under development, but we expect to meet with this committee and the labor committees within the next week to discuss this proposal.

Let me just outline a couple of points in it:

First, it will allow employers to withdraw assets from ongoing pension plans, but it would maintain the protections for retiree benefits.

Second—and this is especially important to the PBGC's funding problems right now—it would significantly strengthen the minimum funding standards to insure employers are required to fund their pension plans.

Mr. Chairman, that concludes my summary.

Chairman ROSTENKOWSKI. Thank you, Mr. Maroni.

[The statement of William J. Maroni follows:]

STATEMENT OF WILLIAM J. MARONI
DEPUTY UNDER SECRETARY FOR CONGRESSIONAL AFFAIRS
U.S. DEPARTMENT OF LABOR
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

February 3, 1987

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to give an overview of the Department of Labor's Fiscal Year 1988 budget and to discuss the legislative initiatives contained in our request.

The Administration's budget calls for $28.3 billion in budget authority for the Labor Department in Fiscal Year 1988 and $25.4 billion in actual outlays.

Outlays for the Department are classified into three major functional areas. In Fiscal 1988, the amounts are:

--Employment and training programs which total $4.9 billion in outlays. This includes funds for the Job Training Partnership Act activities including a proposed Aid to Families with Dependent Children (AFDC)/Youth program and a proposed new Worker Adjustment Assistance program, both of which I will discuss later, Community Service Employment for Older Americans and State Employment Service Operations:

--Income maintenance programs, including benefits paid from the Unemployment Trust Fund, which total $19.1 billion; and

--Worker protection, labor and employment standards, statistics and other staffing, which total $1.4 billion in outlays. These accounts support Federal staff to administer all of the Department's programs.

The Department's overall full-time equivalent (FTE) Federal staff for Fiscal 1988 is 18,600, a reduction of 279 from the Fiscal 1987 ceiling level. Except for planned reductions in certain programs and other planned efficiencies, these staffing levels represent a steady level of commitment of resources to carry out the Department's important legislative mandates.

Equally important, the budget recognizes that changing economic realities present new challenges to American labor and business as we approach the 21st century. We have a number of new initiatives to meet these challenges, and our budget reflects this forward outlook. The proposals are currently in various stages of the drafting and clearance process so I am not able to give a detailed explanation at this time. However, I can discuss the broad parameters of the provisions. We anticipate meeting with your staff and the staff of the Education and Labor Committee within the next ten days to present our concept papers and receive your comments on the proposals. The initiatives are part of the President's Competitiveness proposals and will be transmitted to Congress later this month. Speaking on behalf of Secretary Brock and other officials who administer the programs, we look forward to returning before this Committee to discuss the initiatives at length.

The first legislative initiative is a new worker adjustment assistance program. This program will be responsive to dislocation pressures triggered by international competition, technological change, economic shifts and changes in consumer preferences. We are proposing to replace the current Job Training Partnership Act (JTPA) Dislocated Worker program and the Trade Adjustment Assistance (TAA) program with a single, integrated program of counseling, job search, basic education, literacy and skill training. This new initiative, which would enroll an estimated 700,000 unemployed workers each year, would help displaced workers reestablish themselves in the labor market. A key feature of this new program will be a quick response capability at the state level whereby on-site assistance can be made available immediately when requested and upon announcement of a facility closing or mass layoff. The budget request for this initiative is for $980 million, an increase of $636 million over the currently-enacted budget authority for JTPA and TAA programs.

A second initiative addresses the persistent problems of youth unemployment and welfare dependency. Our new Aid to Families with Dependent Children (AFDC)/Youth program would be authorized by an amendment to Title II of the JPTA revamping the current Summer Youth Employment and Training program. At the option of local officials, funds provided under the program would be available for a year-round program of training, education, and support services for youth in AFDC families, for a traditional summer jobs program, or for both. This proposal would also target resources to areas with the greatest need. The year-round option would give the opportunity for a more intensive remedial program, including such features as literacy components and skill training. It is our hope that this program will help young people on welfare break the pattern of dependency and become productive adults in an America which will desperately need their talents. The budget request for this initiative is $800 million, which is $50 million over the currently-enacted budget authority for the summer youth program and $150 million over our revised Fiscal Year 1987 request.

Other legislative changes will involve the Employment Service (ES) and Unemployment Insurance (UI) programs to give the States far greater freedom of action in constructing truly comprehensive approaches to human resource problems. In 1987, the Administration will propose amendments to the UI laws to decentralize the financing, operation and administration of the UI system to the States. States will determine the level of resources necessary for the administration of their UI programs and collect the taxes needed for administration. The basic UI program will remain the same. Also, in FY 1987, the Administration will propose amendments to the Wagner-Peyser Act to clarify and refocus the labor exchange role of the

Employment Service to give the States greater discretion in the program's administration. We anticipate that these changes will enable the States to focus their public labor exchange services on the special needs of workers in their communities rather than being bound by Federal guidelines and restrictions.

Another legislative initiative for later transmittal involves the Black Lung Disability Trust Fund (BLDTF). Legislative changes will be sought, among other things, to assure that the coal industry pays the full costs of the benefits paid on its behalf, and to permit the systematic retirement of the trust fund debt by the year 2007.

In addition to the above, I feel that I should mention two proposals that will have no current impact on the Department's appropriation, but would improve the Pension Benefit Guaranty Corporation's (PBGC) declining financial status. The first is a separate, comprehensive pension termination and funding proposal. The proposal will contain extensive changes in the minimum funding standard for pensions. Although they will not have an immediate impact on the budget, the changes will in the longer run significantly reduce the underfunding of pension plans and, thus, improve the retirement security of workers and retirees and reduce the financial exposure of the PBGC Public Enterprise Fund. The second proposal would change the amount of premium paid per participant for single employer pension plans from the current fixed amount of $8.50 to a variable rate premium. This increase is necessary to enable the PBGC to meet its benefit obligations and begin to retire its $4 billion deficit.

This concludes my prepared remarks Mr. Chairman. I would be happy to answer your questions.

Chairman ROSTENKOWSKI. Mr. Maroni, I hope when you have your pension legislation prepared that you will work with the Committee on Ways and Means in our jurisdiction.

Mr. MARONI. Yes, sir.

Chairman ROSTENKOWSKI. Secretary Mentz, earlier today I asked Dr. Miller the question about the President's competitiveness package.

As I understand it, the President's competitiveness package mentions the R&D credit and the 861 regulations without being too specific as to what is proposed.

You are aware of what this could cost? As I pointed out to Dr. Miller, I am concerned about the potential revenue loss. Would you like to comment with respect to the 861 and the R&D credit proposals?

I am sure that we are both concerned about losing revenues, and the revenue loss could be large.

I wonder whether you thought about this or whether you could be a little more specific about what the President intended.

Mr. MENTZ. Certainly, I have thought about it a great deal. There is no question that revenue perhaps is the largest concern in developing a proposal, particularly on the allocation of research and development expenses to foreign income.

As you know, the provision enacted in tax reform would allocate 50 percent to domestic income and provide the rest would be allocated under the existing regulation.

Now, if that proposal were to be extended through the budget period, we estimate that it would cost about $2.4 billion.

Anything more generous than that, in the sense—a proposal that would make the percentage higher, allocation of greater expense to domestic income, would, of course, have a greater price tag.

We are in the process of discussing that subject with outside representatives. I believe the Secretary—Secretary Baker—is going to be testifying—is it next week?

Chairman ROSTENKOWSKI. Yes.

Mr. MENTZ. I think that is part of his subject matter. So, I would rather not comment any further in terms of what specific proposals might be forthcoming, other than to say that we are actively involved in it.

The same is true for the credit, as well. An extension—a permanent extension of the credit and possibly changing the percentage also, obviously, has a considerable price tag to it. I think revenue, basically—the proposal has to be, basically, revenue neutral, in our view.

Chairman ROSTENKOWSKI. Well, I hope you are right.

Mr. Levin will inquire.

Mr. LEVIN. Thank you, Mr. Chairman.

Mr. Maroni, let me ask you a few questions about your testimony.

I think for a number of people in the House and the Senate, the proposals that were mentioned in the State of the Union were encouraging.

Some similar ideas have been circulating around here, and I think people were heartened that there would be an initiative

coming from the Labor Department, and apparently, it would be endorsed right away by the President.

So, any questions I have are meant within this framework. I don't mean because they might be pointed that there is any reluctance to express support for the thrust of your proposal.

First, let me ask, in employment and training, how is it going to work when only about 25 percent of the people are receiving income security payments?

You say that you want to emphasize training, not income security. This might more easily work where there was a broad base of income security and people could be trained or retrained.

As you know, a majority of the unemployed aren't receiving unemployment compensation today. How do you handle that in your proposal?

Mr. MARONI. I don't mean to duck your question. Our proposal is, literally, still under discussion. There have been meetings with the Secretary, and we are still putting pen to paper.

To further my remarks about working within the UI system and emphasis on training rather than employment supplements—we believe that the program ought to work with unemployment insurance benefits. In other words, we want to see dislocated workers get into training programs early rather than waiting until UI payments have been depleted.

In cases where there is a need for extended training—and there are in some cases where workers need basic skills training—there may be a need for additional income supplement after unemployment insurance.

Mr. LEVIN. So, you are looking at that aspect of linkage between the unemployment insurance system and training?

Mr. MARONI. We are looking at a way to get away from an overlap of programs. By having one program that is integrated with UI, we feel that we can get people who lost their jobs back to work faster, get them into training programs faster.

Mr. LEVIN. I just want to point out, as you know, it is hard to provide training or retraining where there is no income base for the family, and if you ignore the question of income base, you may not be doing a favor, providing a real opportunity to people by providing retraining without providing that income base.

So, I just mention that to you.

Second, you talked about encouraging notice. Many of us have talked about this—there have been many votes on the floor. How do you think you are going to get at the issue of—if it is voluntary, it may not work where it most needs to work. What kinds of incentives, for example, are you thinking of?

Mr. MARONI. Voluntary notification for plant closings or mass layoffs is something that we have encouraged as a matter of course, and something the Department of Labor does through the Bureau of Labor Management Relations and Cooperative programs.

We try to get in early where we know of a problem within a community. Under this proposal, there would be an opportunity for States and local organizations to offer plants the formation of labor management committees as well as on-site—right there at the plant—training and counseling for workers.

We believe that most of the companies want to provide this. They want to provide early notice. This is an opportunity in the way this program would be designed, we would hope, to really encourage companies to come forward when they know there are going to be mass layoffs, and work with the Governor and the local agencies that are involved in this area.

We are not talking about a financial incentive, but rather a way for companies to keep good will in the community.

Mr. LEVIN. We will have to be talking much more about this.

Going back—as my time finishes—to unemployment insurance, I would hope as you finish your work that you might take another look at some of the reform proposals, including those that have been presented over the years by Mr. Pease.

As we put together some ideas in this area, it became clear that if you totally ignore the fact that now over 70 percent of the people who are unemployed receive no unemployment insurance, when you prepare ideas on training and retraining, that you really are going to miss a large number of people who need the training and retraining opportunity.

I know there is money involved, but if you ignore the reality of the narrow coverage today of unemployment comp, you are going to ignore great areas of need.

Mr. MARONI. Mr. Levin, let me just say two things.

One is that no one who would be receiving UI currently would lose UI benefits under our plan.

Mr. LEVIN. I understand that.

Mr. MARONI. Second, the eligibility for this new program, we would envision, would be the same as the eligibility under the Job Training Partnership Act for dislocated workers, which includes self-employed people, farmers, the like, many of whom would not receive UI now.

So, we have in mind broad coverage, just as broad as the current JTPA program.

Mr. LEVIN. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Schulze will inquire.

Mr. SCHULZE. Thank you, Mr. Chairman.

Welcome, gentlemen.

First, I will start with Secretary Mentz. Roger, nice to have you here.

Roger, economic growth is relatively slow and investment is not what we would like to see it. Productivity, according to the 1987 economic report of the President, is low or lower than we would like to have it.

My question is, if our economy stagnates, would the administration be willing to consider reinstating a 5 percent investment tax credit if it were narrowly drawn and targeted to productive equipment and machinery only?

I understand this would cost as little as $6 billion a year on a static revenue basis without any stimulus factored in or reflow.

I would just like to have your thoughts on that.

Mr. MENTZ. Well, Mr. Schulze, I am not sure I would agree with the characterization of the state of the economy. I think what I have been reading lately, the most recent Business Week, particu-

larly, said manufacturing seems to be strengthening. The rate of inflation remains low; interest rates remain fairly steady.

I know it is—Secretary Baker anticipates that the 3.2 percent assumed real GNP growth in 1987 will be realized. So, I would quarrel with your assumption——

Mr. SCHULZE. I am not assuming that.

Mr. MENTZ. I am sorry. Not your assumption, your hypothetical.

Mr. SCHULZE. Things could be better.

What I am saying is, if we reach a period of stagnation, if it becomes obvious that the economy is not performing as we would like it to, it seems to me that that would be an obvious avenue to pursue.

I just wondered whether that would be one of the early things you would consider or whether you would target other areas.

Mr. MENTZ. I think the administration has the feeling that we rearranged the tax law so many times over the last 10 years, particularly recently, that it would be better to allow the American people a chance and business, particularly, to understand the new tax law and not start tampering with it and making changes when we see—if we see a little flutter in the economy.

So, I don't think you will find the administration looking toward an investment credit type proposal to give the economy a boost if it is perceived to be sagging.

I think if some sort of stimulus is needed—you hypothesize—I think this administration would be looking for some nontax way of doing that, dealing with that.

Mr. SCHULZE. Roger, do you see or does the Treasury see any unintended or surprising economic effects from the Tax Reform Act, particularly in the area of investment in manufacturing?

Mr. MENTZ. We are monitoring that. I have asked the staff, particularly the Office of Tax Analysis, to carefully monitor what we can perceive to be the effects, not only on manufacturing investment, but on financial institutions.

So far it is too early to tell. Obviously, the stock market is very positive. I don't think we can attribute that to tax reform.

Mr. SCHULZE. Even if it is too early to tell decisively, can you give me your current figures on investment in machinery?

Mr. MENTZ. I will get them for you. I don't have them off the top of my head.

Mr. SCHULZE. Let me address some of your specific proposals.

The repeal of the gasoline highway excise tax exemptions—does that include inner-city buses? The school buses for example, while a relatively small item, will have to be picked up on the local level. We provided the inner-city bus exemption because the poorest of the poor use inner-city buses for transportation. It seems we are getting picky to rescind some of those items.

Mr. MENTZ. It is a very sort of broad gauge proposal that just says, "Get rid of all the exemptions." It is all user fee, every bus tears up the road the same as every other bus. I recognize it is the prerogative of Congress to balance and weigh and make distinctions.

Mr. SCHULZE. Let's review the BATF proposals. Can you give me a rough idea how much those excise taxes bring in now? It seems to me they may not be user fees.

Mr. MENTZ. You mean the excise taxes on alcohol?

Mr. SCHULZE. Alcohol, tobacco, fire arms.

Mr. MENTZ. They were enormous numbers. They were well into the billions.

Mr. SCHULZE. It seems that we are again splitting hairs if we suddenly decide that the current fees do not cover the services provided.

Have you thought about an alcohol equalization tax in this proposal?

Mr. MENTZ. Well, we thought about it. In fact, thought about it in the sense that that was a proposal, you may recall, that Senator Packwood made back in the early days of tax reform on the Senate side.

As a matter of fact, I testified on it. It had very little political success in the Senate Finance Committee, despite my persuasive testimony.

Mr. SCHULZE. Thank you. I have other questions, but I will move to Secretary Maroni.

Mr. Secretary, I have been unhappy with the way in which plants and individuals and unions and groups have been certified under the trade adjustment assistance program. Has thought been given to a set of official rules so that the criteria for recipients is less subject to variation?

In other words, I am aware of two plants in two different States manufacturing the same product that were shut down. One received assistance and the other group of workers did not.

You see, that, means, in my opinion, that there is too much latitude in the decisionmaking process. That is one of the reasons why I have been opposed to it. Have you given any thought to straightening that out?

Mr. MARONI. This is certification under trade adjustment assistance? I can't understand why that would have happened. The two plants made the same product?

Mr. SCHULZE. Yes. Because you can send out a questionnaire, as you know, and if you word the questionnaire differently, you can get different responses. I could design a questionnaire to get different responses.

In my opinion there is too much latitude. If you clear that up so that the program is administered on an equitable basis, I will be happy to support it.

Mr. MARONI. Well, one of the reasons behind our proposal is to get away from certification of workers for assistance based on trade problems or imports. We have found, through experience, and in fact the Secretary's Task Force on Plant Closings and Dislocated Workers found this also, the needs of dislocated workers are substantially the same, whether you have lost your job because of trade or technology or whatever.

Our proposal would not have a complicated certification process here in Washington because it would be located at the State level. It would build upon the local and State organizations that are already there to get funding to the people.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. Thank you, Mr. Chairman.

On student income, Mr. Mentz, you might have covered this, but I want to revisit it if you have. The administration is recommending part-time work by full-time students working for colleges be covered under FICA.

Mr. MENTZ. That is right. There is no distinction. It would be part-time. That is right.

I might note there, there is sort of an advantage under current law for a university to hire a student, and if they were to hire someone not a student, the employer has to pay the FICA tax as well as the employee.

Mr. JENKINS. Now it is more attractive for them to hire a student?

Mr. MENTZ. That is right.

Mr. JENKINS. That may be a good reason to have the differentiation; if you want to give students help, to give them a little financial edge. I just want to make sure that that is the proposal.

On the restaurant provision in your statement, I am not sure that I fully understand that. In reading your statement and listening to your explanation, you are saying that tips reported to the IRS by employees do not have an employer's FICA share withheld. Is that correct.

Mr. MENTZ. That is correct. But the employee does.

Mr. JENKINS. OK.

So, at the end of the year, the employee pays the full FICA tax on the tips under existing law.

Mr. MENTZ. Pays the full employee share of the FICA tax.

Mr. JENKINS. But does not——

Mr. MENTZ. But the employer does not pay the full employer share.

Mr. JENKINS. Does the employee pay that at the self-employment rate, or is it——

Mr. MENTZ. Not self-employment; pays it as an employee.

Mr. JENKINS. As an employee.

So, you are losing the employer's part on the amount that is reported by the employee, that is above his or her wage.

Mr. MENTZ. Precisely.

Of course, the concept is tips are treated as if paid by the employer. They are subject to wage withholding. And that is the theoretical basis for the employee paying full FICA on the full amount.

There is effectively a gap in the statute that doesn't pick up the employer portion above the minimum wage.

Mr. JENKINS. Well, now, since the employee is reporting these, there is no difference in the amount of Social Security that that person would receive?

Mr. MENTZ. That is right.

Mr. JENKINS. There is no benefit to the employee as far as Social Security benefits?

Mr. MENTZ. None whatsoever. He is covered the same whether this proposal is adopted or not; that is right. The only benefit is to the employer who gets away with less of a Social Security tax.

Mr. JENKINS. That has been in the law under the theory the employer was not really paying the tips to the employee; is that right?

Mr. MENTZ. I am not sure what the theory may have been originally, but it doesn't really hold together under current law because

the theory is that the employer is paying the tip, and that is the basis for full wage withholding and full FICA tax to the employee. So, the theory is internally inconsistent under current law.

Mr. JENKINS. I know we have had a problem through the years of attempting to get tips reported so that they can be included in income for tax purposes. I am wondering if you are really opening the door without really intending to. It would be to the advantage of an employer under this new proposal, it appears to me, to have the employee report as low an amount in tips as possible, because that would reduce the amount the employer would then have to pay under FICA.

Wouldn't that be the end result, if there are such employers that might do that?

Mr. MENTZ. I can see an advantage to which you are referring. If you assume that the employee has unlimited or some flexibility to report as he chooses——

Mr. JENKINS. I assume that flexibility is there.

Mr. MENTZ. Of course. The greater advantage, one would think that under current law it would be to the employee's advantage to do that, because he would save FICA tax himself. One would think that would be a stronger motivation than trying to help the employer's tax saving.

So, I would suggest that maybe the motivation is already there.

Mr. JENKINS. Well, it is just something I would assume that you all have looked at and do not feel there is any real problem with it.

Mr. MENTZ. No real problem beyond the basic problem of having accurate reporting of tips, which, you know, is one that we have struggled with, as you say, over the years. I don't think this exacerbates it.

Mr. JENKINS. I think my time is up. Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Pease will inquire.

Mr. PEASE. Thank you, Mr. Chairman.

Welcome, gentlemen.

First of all, Secretary Mentz, I would like to discuss with you the proposal to repeal the windfall profits tax. I note that the current market value of oil is just about equal to the base price for a tier 1 well under the windfall profits tax.

Doesn't that mean if there should be complications in the Middle East because of the Iran-Iraq war, and the price should go up, that we would be missing out on significant amounts of revenue by repealing this windfall profits tax?

Mr. MENTZ. Well, if the price were to go up—your point is, while there is no revenue now, under current market conditions, if the price goes up there would be greater revenue. That may be true, but I would suggest to you that the original windfall that was sought to be clawed back or recaptured with the tax was the windfall that would occur, and did occur, when price controls were lifted and the oil price shot right up to market.

Now we are down at a market of $18 or lower, and that is not really different than the price of automobiles or ice cream. If the price of ice cream goes up, one could argue, well, we ought to have a windfall tax on ice cream to pick up that tax revenue.

I think my point is an increase in the market price of oil from $18 isn't really the windfall that was anticipated when the tax was enacted.

Now, would it produce revenue? Yes. Can we use revenue in these times? Sure. That part I have to agree.

Mr. PEASE. I think that is really my point. The windfall profits tax is due to be phased out anyhow in the 1990's, and we do have a potential here to help reduce the deficit, which I know the President is interested in. I think it may be ill-advised to repeal the windfall profits tax ahead of the normal schedule for that very reason.

Let me turn to the coverage of State and local employees under Medicare. I talked this morning with the Director of OMB, who said time and again that the President is opposed to any tax increase. You have said that in your own testimony today. But, requiring States which are not now covered by Social Security to start paying the Medicare tax for current employees would impose a significant additional burden.

In my congressional district, in my State of Ohio, the only recourse school districts have to raise money is a local property tax. There have been a lot of property tax levies on the ballot. You would be imposing an additional burden of about $50 million in Ohio on school employees alone under this proposal.

You also propose repealing the exemption from the diesel fuel tax and the gasoline tax for school buses. That would impose an additional tax.

The concern I have is that, while the administration keeps talking about not wanting to increase taxes, what it really means is it doesn't want to increase taxes at the Federal level; but it doesn't mind forcing tax increases on local officials.

Is that a fair statement?

Mr. MENTZ. Well, I wouldn't think so. But probably there are those who would.

I think that on the Medicare coverage of State and local, the rationale for that is OMB estimates that about 75 percent of employees of State and local governments who did not elect to be covered are nevertheless covered by Medicare because of a spouse or a parent who is on Medicare; and, therefore, they have Medicare benefits. And there is kind of a fairness point that everyone else—when there is two spouses working, there is double payment and double coverage. But that is not true of State and local employees, where they are in a State that did not elect the Medicare coverage.

On the fuel exemption, I think the theory there is to rid of all exemptions for diesel fuel and alcohol fuel, and so forth, and basically if we are talking about a user fee, the funds eventually go to build and maintain roads, that there really isn't any logical distinction between a school bus and a truck that is in a commercial venture, and if it is a user fee, there shouldn't be any exemptions.

As I think I answered earlier, that doesn't mean that Congress won't find reason to make certain distinctions.

Mr. PEASE. I understand the principle, but the effect of it is, nonetheless, that the administration proposals for State and local coverage under Medicare, and removing the State and local government fuel exemption would force increased costs along to State and

local governments, which would have to raise taxes in order to get that revenue.

Mr. MENTZ. I don't think that is what the President means when he says he doesn't want to raise taxes. When we went through tax reform last year, we did a lot of things that broadened the base; and, without any other State action, States that are tied in to the Federal base would have the tax receipts automatically go up because the rate would stay the same and the base would be broader.

I don't think it would be fair to characterize that as a tax increase. It is a collateral effect of a Federal action that has a tax effect at a State or local level.

I think what you are talking about, if it is necessary for a municipality or a State to produce revenue in order to make up for elimination of a tax exemption on diesel fuel, I don't think the President would think of that as a tax increase. I think that is a collateral effect.

Mr. PEASE. A rose by any other name.

Thank you.

Chairman ROSTENKOWSKI. Mr. Chandler will inquire.

Mr. CHANDLER. Thank you, Mr. Chairman.

If I may, I would like to address a question to Mr. Maroni concerning the Pension Benefit Guarantee Corporation. I have a general concern, and I am going to address a letter to you with more specific questions.

We went from a premium of $2.60 per employee, as I recall, to $8.50 per employee last year. Since then there has been the LTV termination and other major failures and terminations. Will any employer pay the same or a smaller premium under the administration's proposal? How high do you think the premium potentially might go?

My real concern is, at what point does the premium get so high that the premium itself begins to discourage the continuation of plans and, in fact, brings about plan terminations?

Mr. MARONI. Mr. Chandler, those are precisely the kinds of questions we are grappling with. You can construct a variable rate premium virtually any way you want to come up with any kind of high number or low number. We are, in conjunction with the PBGC, looking at a number of different ways to do it.

We would prefer to keep—for most people, we would prefer to keep the premium where it is. We do not want to see a large percentage of employers paying an exorbitant premium. That would be counterproductive.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

If the administration was to talk about enterprise zones at all, would this be the time they would have raised it?

Mr. MENTZ. Not necessarily, Mr. Rangel.

Mr. RANGEL. You mean it is possible that this will become an administration proposal some time this year?

Mr. MENTZ. It is possible. I haven't—I have heard some mention of enterprise zones. As you know, it is not in the budget and, therefore, it was not included in my testimony. But I would say it is certainly not completely off the table.

Mr. RANGEL. If it did come up, it would go through your shop, wouldn't it?

Mr. MENTZ. Oh, yes, I would hope so.

Mr. RANGEL. OK.

This morning, Dr. Miller had indicated that there might be some additional Government receipts that were not specifically included in the user fees and asset sales. Would you know whether they would be considered taxes?

Mr. MENTZ. No, I wouldn't. I don't know what he was referring to, Mr. Rangel.

Mr. RANGEL. The President indicated in his State of the Union Message that he had some other ideas that might help us to reach our deficit reduction goal, but he didn't want to show those to us until we showed him our proposals.

Do you know what the President was talking about?

Mr. MENTZ. No, I don't.

Mr. RANGEL. With the targetted jobs at the Department of Labor, are you having any problems getting the statistics that are necessary where we mandated that the States send you the information on these people?

Mr. MARONI. To my knowledge, we are not.

Mr. RANGEL. You have no problems at all? The information is being collected from the State employment services?

Mr. MARONI. That is correct.

Mr. RANGEL. Could you check that out further and verify your response to me, because I am very concerned with the output? With the removal of the exemption from gasoline taxes of public buses, I thought that was not a tax matter, but a public policy matter.

Was there any discussion about the conservation of gasoline versus private cars achieved by the use of buses, which, after all is why we gave these exemptions? Was that an issue, or was it just a revenue-raiser?

Mr. MENTZ. It wasn't really an issue. At least it wasn't a consideration that was considered important, important enough to change the proposal.

Mr. RANGEL. But was it discussed?

Mr. MENTZ. Well, I think you are right that there clearly is a conservation element in that exemption. It drives people toward public transportation.

Mr. RANGEL. I just want to know whether you looked at it. Some of these things I don't think you really expect us to do, but I just wanted to know whether you considered it.

On page 17 of your testimony, you referred to increasing IRS funding and picking up $2.4 billion. Is this the same proposal that was $17 billion that the White House presented to us during the tax reform?

Mr. MENTZ. You mean the trust fund?

Mr. RANGEL. The trust fund.

Mr. MENTZ. We are holding that in reserve, Mr. Rangel, so when we really need money we will come out with the trust fund.

This is a proposal that will be elaborated upon by Commissioner Gibbs of the IRS. But it basically is an appropriation of $624 mil-

lion, I believe, specifically targeted to various aspects of IRS administration and enforcement that is designed to produce $2.4 billion.

Mr. RANGEL. Is this worked on some formula—the more money you give them, the more money you collect?

Mr. MENTZ. It is based, as I understand it, on experience with IRS; in other words, statistical results of IRS performance in the past.

Mr. RANGEL. Well, it is creative, and I just wondered whether or not we can get more money out of this if we increase the IRS budget even more than you are recommending?

Mr. MENTZ. Again, this is not my jurisdiction, but as I understand it the question was put to the Commissioner: What would be a practical limit on how much you could absorb? In other words, you couldn't give him $20 billion and produce $80 billion.

Mr. RANGEL. How was he going to raise the $17 billion for the trust fund before? Wasn't it by making more effective or efficient the collection process?

Mr. MENTZ. That was part of it, and I think there is—my recollection is there is some revenue in tax reform that results, that comes from improved IRS enforcement, collection, and so forth—of course, not a trust fund, but that general concept.

I believe there was some revenue in reconciliation last year on that, as well.

Mr. RANGEL. I am just asking, is there any more revenue in that package that we could use to apply to reducing the deficit as opposed to placing it in a trust fund?

Mr. MENTZ. Well, this does go to reduce the deficit.

Mr. RANGEL. We were talking about $17 billion over a 5-year period, I thought.

Mr. MENTZ. Yes. You are back to last summer.

Mr. RANGEL. Yes; same administration.

Mr. MENTZ. I don't believe that there is any further juice in that apple, if that is what you mean.

Mr. RANGEL. That is what I meant.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Flippo will inquire.

Mr. FLIPPO. Thank you, Mr. Chairman.

I did have a question of the Secretary. Mr. Mentz, I noted on the front page of the report that it is extremely important that we do not undo any of the dramatic and important tax reforms that were accomplished last year. I certainly agree with that.

I would like to refer you to page 10 where—9, rather—where your recommendation in regard to coal, I believe, is made. Last year, you will recall, I am sure, we reviewed workers' compensation and black lung benefits for individuals. These matters were debated at great length at that time. In the end the House, the Senate, and the administration seemed to have reached some agreement in regard to these matters. At least the President signed the bill that contained some agreements in regard to these matters.

At that time, it was pointed out that the black lung benefits, the level of those benefits, were determined with the fact in mind that the benefits were received and not included in taxable income. So the level of benefits were determined by that fact.

If we now change that and adopted the administration's recommendations, it will result in, in effect, a reduction in the value of those benefits to those recipients. I think that this is one of the areas in which we have achieved tax reform already, and it just seems like it is somewhat inconsistent with the agreements reached by both the House and the Senate and the administration last year.

I wonder if there have been, since last year, any studies conducted that would tell us the impact of this proposal on the competitiveness of coal; and I wonder if you could tell us what the reduced revenues might be? Would coal sales be expected to be reduced significantly because of the increased tax? Isn't this a violation of the agreements that were worked out last year?

Mr. MENTZ. Well, I well remember last year, as you know, and the year before that. What is referred to in the beginning of my testimony is primarily a concern that we not go back on the essence of tax reform which was a broadening of the base and a lowering of the rates.

I think my main point is we need to resist, and resist staunchly, any temptation to get the rates up, because that is really a violation of what I think was the basic understanding of tax reform. I don't think that because we missed a base-broadener in tax reform that necessarily that means that is off the table forever and ever.

I think that the taxation of black lung—and, by the way, Treasury I and the President's proposal included all black lung compensation, and proposed it to be income. But the question on the tax, the proposal before you, is just the income replacement aspect of black lung compensation. The theory there, I think, is the same, and we argued it the same way, as for unemployment compensation; that is, it is a substitution for taxable income, compensation.

With tax reform, we have got a newer rate system, a more modern one. And we have taken care of certainly the lower income people. They get the largest reductions in tax. So, the effect is that if a relatively low income person has a black lung benefit, chances are with tax reform he is not going to pay any tax anyway. If he happens to be in the higher income bracket, which most of them would not be, tax reform would be functioning correctly, and including it in taxable income.

That is the argument. That argument did not prevail last year. I guess the old, you know, "Try it once; if you don't make it, try it again"—I guess that is where the administration is coming from.

On the other part of your questioning, maybe Mr. Maroni might be better able to answer than I.

Mr. MARONI. I would just add, Mr. Flippo, the problem that the Administration is trying to solve is the growing indebtedness of the trust fund. Your question about competitiveness of the coal industry is one of our concerns. We didn't feel that we could solve the trust fund indebtedness simply by putting a higher and higher and higher tax on the coal industry. We felt, in fairness, we ought to look at some of the future benefit costs as well as a tax increase, look at both sides of the equation.

Mr. FLIPPO. Well, I understand the necessity of trying to protect the trust fund. But it just looks like your proposal is a rather severe one because you are talking about removing from the gener-

al fund the burden of paying the interest on this now, and that would be put back in as a further burden to the trust fund. You are talking about freezing the cost of living adjustment for the benefits under this proposal, and you are talking about taking something that is basically nontaxable now and making it taxable, and you are talking about increasing the excise tax on the coal.

So, it seems that one should be concerned about competitiveness as well as equity, because there is no doubt in my mind that the value of benefits under black lung would be significantly reduced under your proposal.

Thank you very much.

Chairman ROSTENKOWSKI. Mr. Crane will inquire.

Mr. CRANE. Thank you, Mr. Chairman.

I want to express appreciation to you, Mr. Secretary, for your testimony. There has been talk of addressing the budget problems for 1988 by freezing the tax rates which are in place for 1987, and which are scheduled to be reduced further in 1988. I sought from the Joint Committee on Taxation a breakdown of what the impact would be of freezing the 1987 rate structure in place for 1988.

According to the Joint Committee's analysis, from zero to $10,000 there would be a 51-percent reduction in income tax liability. There would still be reductions up to the $30,000 to $40,000 income bracket, which would have a 2.4 percent reduction. However, such a freeze would result in a tax increase for every bracket—$40,000 to $50,000, $50,000 to $75,000, $75,000 to $100,000, $100,000 to $200,000, and $200,000 and over—starting at $40,000, which would have a 0.2 percent increase. When you get to $200,000 a year, it is a 13.2 percent increase.

I was wondering if you could provide me with an analysis of such a freeze policy so that your figures may be compared to those of the Joint Committee. The reason I am concerned about this proposal is because it has been suggested by our Speaker when he was Speaker-designate in December. We have heard discussions of this from other sources, and frankly I think it would be a very counterproductive move.

If you could provide the committee and myself with this information, as the Joint Committee on Taxation has done, I would appreciate it.

Turning to one other subject, in the January 29 issue of the Bureau of National Affairs, it was indicated that the Treasury Department is anticipating an increase in Federal revenues as a result of the changed treatment of capital gains, whereby the maximum rate is 28 percent in 1987 and will be 33 percent in the years thereafter. Apparently, Treasury is anticipating a revenue gain of $21.8 billion between the years 1987 and 1991.

In a publication from the Treasury Department in September of 1985 on the subject of capital gains, the findings implied that any effort to raise substantial revenue by increasing capital gains tax rates, given the current parameters of the tax law, was likely to be ineffective. That same study concluded that prior reductions in capital gains tax rates had resulted in increases in economic growth, capital formation, productivity, long-run consumption levels and incentives for private saving.

I am wondering, first of all, if you still conclude that the reductions in the capital gains tax rates prior to the 1986 tax law had these positive, beneficial effects with regard to savings, investment, productivity, consumption?

Mr. MENTZ. Well, let me just first comment on your first point. I think you have articulated very effectively the problem with freezing the rates; 1987 is a transitional year. It was never looked at by this committee or the Senate Finance Committee or Treasury as the year in which you focus what is going to happen on tax reform. And the whole concept of tax reform was geared to getting to 1988 and having the rate at 28 percent. I think that was really the way the deal was worked out.

The administration would be very strongly opposed to any freeze for 1987, because 1987 was really a transitory period. I will be pleased to get you the figures. They will support exactly what you have expressed, and they will be fairly consistent with the Joint Committee.

Mr. CRANE. In fact, if you will yield on that point, the 1987 brackets that are in place for this year represent tax increases starting roughly at the $50,000 to $60,000, or $50,000 to $70,000 range. They are not as substantial as the ones that the Joint Committee on Taxation says would exist, of course, in 1988, if the same rates were extended another year. So, it does represent a fairly good tax increase, especially for people in upper income brackets.

Under the Tax Reform Act, there is in 1987 a 9.8 percent tax increase for the $200,000 income bracket and above. That would increase, to over 13 percent if the 1987 tax rates were extended to 1988.

Mr. MENTZ. Not to get too technical, I think it also makes the passive loss rule extremely unfair. The passive loss rule is fair on the basis that you are taxing the individual income tax base without offset for losses at a low rate, at a 28 percent rate. If you jack that right up to 38.5 percent and leave it there, you have a lot of folks jumping off the ship—and I am sure many in this committee. So, I am very strongly in agreement with you.

Moving to the capital gains point, the increase of rate on capital gains produces behavioral responses that Treasury measures differently than does the Joint Committee, and this is the single biggest disagreement between our revenue estimators and those of the Joint Committee as to how much revenue is raised by tax reform.

The reason that we show this $21.8 billion over five years is roughly, I think, a 20 percent increase in the revenue from capital gains. A large portion of that is generated, was generated, by the end of 1986, and it is because of again behavioral response, people who anticipated a higher capital gains rate and sold before 1987 in order to take advantage of the lower rate.

I think that if the administration really had its druthers on capital gains, we would have a lower capital gains rate. But I think we are where we are, and we are very happy with tax reform. That is certainly not a proposal.

I think Secretary Baker said in his testimony last week that that was the single biggest disappointment of tax reform. But tax reform is done. It is a package. We are not looking to change any part of it. We are trying to keep it together.

Mr. CRANE. Mr. Secretary, my time has expired. But if you have not yet seen it in the October 27, 1986, issue of Special Reports, there is mention of a study by Lawrence B. Lindsey, "Rates, Realizations and Revenues: Capital Gains in Taxes and Capital Formation," edited by Martin Fornstein. The case is made very persuasively that every time the capital gains tax rate was lowered, revenues were increased significantly, as was capital.

Inasmuch as we are trying to reduce the budget deficits, based upon past experience, it would seem to me that this is not an inauspicious time to review the treatment of capital gains in the Tax Reform Act. We may find, as we did in the past, that by lowering the capital gains rate we can achieve all of those desired objectives that were stated in the 1985 Treasury publication, and simultaneously increase revenues. On balance, I think it is a project worth consideration.

I would buck that to my distinguished chairman here, because perhaps we could achieve that blissful ideal of a Lindsey "maximization of revenues", which Lindsey contends would occur at a 16 percent rate for capital gains. I have a bill to reduce it to 10 percent. But if you folks could volunteer anything on that for future debates, I would appreciate it.

Mr. MENTZ. Well, I am familiar with Larry's report on that. Clearly, there is some optimum point of capital gains tax where you maximize revenue. I don't know that Larry knows really where it is, and I am sure I don't.

I think on kind of a broader plane, while we may agree with you in general that capital gains rates are important, and the lower the rate, the better it is for the economy, I think we have to look at that as one piece of the tax reform package. And once you start unwinding it, even on something that you and I may agree is desirable, I think you open up the prospect for lots of other changes that we would both agree would be undesirable.

Mr. CRANE. And many, Mr. Secretary, would be very desirable.

Chairman ROSTENKOWSKI. Thank you, Mr. Secretary, and thank you Mr. Maroni. Thank you very much for joining us this afternoon.

The committee stands adjourned.

[Whereupon, at 3:40 p.m., the hearing was adjourned, to reconvene at 10 a.m., Wednesday, February 4, 1987.]

# OVERVIEW OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1988

WEDNESDAY, FEBRUARY 4, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, DC.*

The committee met, pursuant to call, at 11 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. The committee will come to order.

Today we continue the committee's hearings on the President's fiscal year 1988 budget. These hearings focus on the economic implications of the President's budget as well as alternative ways of meeting the Gramm-Rudman deficit reduction target.

Our witness today, Dr. Rudolph Penner, Director of the Congressional Budget Office, is somebody that is very familiar to this committee.

The latest CBO estimate of the deficit for fiscal year 1988 is $169 billion. If that is correct, we face a $61 billion deficit reduction effort in order to meet the Gramm-Rudman target of $108 billion, rather than the $42 billion estimated by OMB. CBO estimates that even if we were to adopt each and every budget recommendation of the President, we would still fall $25 to $30 billion short of the goal.

The lion's share of any deficit reduction plan will be the responsibility of the Committee on Ways and Means. To meet that responsibility, facts about the deficit and a clear understanding of the economic consequences of our decisions, as well as CBO's analysis of the President's budget, the state of the economy, and the impact of various deficit reduction measures will be very important to the committee in the coming months.

Blue smoke and mirrors will not reduce the deficit to the $108 billion target. We look to CBO to provide us a true barometer of the pain required to achieve that target. I note that CBO's annual menu of spending reduction options is being unveiled today, and I recommend it to the members. It will help to remind us of the deficit job that we, on this committee, face.

Dr. Penner, we look forward to your testimony. I might add a note of appreciation for all the cooperation that you have extended to our committee. I know that toward the end of this month we will not have the benefit of your personal leadership at CBO. However, I am sure that any time this committee or any member wants

to call on you for your personal recommendations, you would be ready to do that.

Mr. PENNER. Certainly, sir.

Chairman ROSTENKOWSKI. Mr. Duncan is recognized.

Mr. DUNCAN. I would also like to welcome Dr. Penner again to the committee. I know a great many of us are going to miss the benefit of your services as CBO Director. Although as the chairman mentioned, I know we can always call upon you for advice. I think you have done an outstanding job in a very difficult situation and I want you to know we appreciate your efforts.

I look forward to your comments today. I did want to add that, in my opinion you have been one of the best public servants in the Government.

Mr. PENNER. Thank you, sir.

Chairman ROSTENKOWSKI. Dr. Penner, we are ready for your testimony.

## STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. PENNER. Thank you for your kind words, Mr. Chairman, Mr. Duncan. I have very much enjoyed working with this committee. It has been one of our best customers; and, while there have been a few rocky times, for the most part it has been a very pleasurable experience.

I am certainly willing, any time, to offer my advice at the same price CBO charges, which is zero.

I am here today to discuss the economic and budget projections, along with the deficit reduction options of the Congressional Budget Office. The projections are described in detail in the CBO report titled "The Economic and Budget Outlook." Today, as you noted, we are also releasing our annual menu of options for reducing the deficit. I should emphasize they are only options. They are certainly not recommendations. Many are quite appalling to a lot of people, I am sure; but we have tried, as best we can, to state the pros and cons for particular options.

We project that under current taxing and spending policies, the federal deficit will decline from its record high of $221 billion in 1986, to $174 billion in 1987, $169 billion in 1988, and $85 billion in 1992.

These budget projections are contingent on CBO's forecast of a moderate pickup in economic growth from its subdued pace in 1986, and a modest decline in both short-term and long-term interest rates over the projection period from their average levels in 1986. They also assume that both defense and nondefense discretionary appropriations are held to zero real growth. The budgetary outlook and the economic assumptions underlying the forecast are presented in table 1.

The economic expansion has now entered its fifth year. Over the four quarters of 1986, the economy grew at a 2½-percent rate—about the same as in 1985 but substantially below its growth in the first 2 years of recovery. Unemployment in 1986 was slightly below that of 1985, but still averaged 7.0. Total employment grew rapidly, however, by about 2.3 percent.

Most of the new jobs were in the service-producing sector. Growth in employment in the goods-producing sector continued to be weak, which is at least partially attributable to the widening trade deficit. The trade deficit was, in turn, partly the result of the high budget deficit. The latter has necessitated a large amount of borrowing from abroad, which has pushed up the value of the dollar until recently and made it more difficult for U.S. producers to compete with foreigners.

Inflation decreased in 1986, especially as measured by the Consumer Price Index (CPI), largely because of the precipitous decline in oil prices at the beginning of the year. Despite the continuing depreciation of the dollar against most other currencies, prices of imports did not move up as sharply as many forecasters had anticipated, nor did the import surplus decline as had been expected. Interest rates—especially long-term rates—fell considerably as a result of the easing of inflation, the sluggish growth of the economy, and the expectation of lower Federal deficits.

CBO forecasts a moderate pickup in economic activity in 1987 and 1988. Real GNP is expected to grow just under 3 percent annually, which should bring unemployment down to an average of 6.6 percent in 1987 and 6.5 percent in 1988. Like most other forecasters, CBO anticipates that the trade sector will be the major contributor to the stronger growth.

CBO's forecast calls for a rise in reported inflation, between 2 and 2½ percent in 1986, as measured by the implicit GNP deflator, to about 3.7 percent in 1987-88. On the consumer level, CBO sees inflation rising even more sharply—from the artificially depressed rate of about 1½ percent in 1986, to almost 4½ percent in 1987 and 1988. The rise in inflation will reflect, among other things, somewhat higher oil prices and rising import prices caused by the falling dollar. Nominal interest rates in 1987 and 1988 are expected to stay at about their present levels.

Under these economic assumptions, as I said before, CBO projects a sharp decline of the baseline budget deficit in 1987 and a further moderate reduction in 1988. About half of the expected decline in the 1987 deficit results from one-time factors, including an increase in revenues under the Tax Reform Act of 1986, asset sales, and shifts of outlays into adjacent years.

After 1987, revenues under current laws are projected to grow at an annual rate of nearly 8 percent—slightly faster than GNP—while baseline outlays grow only 5 percent per year, which is substantially below the 10-percent annual growth rate experienced earlier in the 1980s and less than the projected growth in the economy.

Figure 2 summarizes recent trends, and the CBO baseline projections for the major categories of federal spending. Nondefense discretionary spending has been curbed most sharply, falling from 5.8 percent of GNP in 1980 to 3.8 percent in 1987. Spending for national defense was fed by sharp real growth in appropriations in the early 1980s, followed by small real cuts in the last 2 years. These cuts and the CBO baseline assumption of zero real growth in budgetary authority would put the defense share of GNP on a downward trend over the next few years.

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Under current law, entitlement spending should remain at a steady share of slightly below 11 percent of GNP through 1992, although that category includes agricultural price supports, a notoriously difficult program to project. Price support spending has tripled in the last decade, and will continue to be affected by the weather and by foreign developments.

Finally, net interest spending, driven up first by rising interest rates and then by rising deficits, should begin to fall as a share of GNP as these two factors are reversed. Any deficit reduction plan would most probably earn a bonus in the form of lower interest costs.

Mr. Chairman, the rest of my testimony describes in a little bit of detail some of the options for deficit reduction that we have in the report released today. With your permission, I will just submit that for the record and now answer your questions.

Chairman ROSTENKOWSKI. Without objection, so ordered.

Thank you very much, Dr. Penner.

[The statement of Mr. Penner follows:]

Statement of
Rudolph G. Penner
Director
Congressional Budget Office

Mr. Chairman, it is a pleasure to appear before this Committee to discuss the economic and budget projections, along with deficit reduction options of the Congressional Budget Office (CBO). The projections are described in detail in the CBO report titled *The Economic and Budget Outlook: Fiscal Years 1988-1992*, which was released last week. Today, we are releasing the 1987 version of *Reducing the Deficit: Spending and Revenue Options*. In my testimony this morning, I will discuss:

- The economic forecast for 1987 and 1988, and projections for 1989-1992;
- The CBO baseline budget projection; and
- Deficit reduction options.

## CBO'S ECONOMIC AND BUDGET PROJECTIONS

The Congressional Budget Office projects that, under current taxing and spending policies, the federal deficit will decline from its record high of $221 billion in 1986 to $174 billion in 1987, $169 billion in 1988, and $85 billion in 1992. In relation to gross national product (GNP), the deficit is projected to decline from 5.3 percent of GNP in 1986 to 3.6 percent in 1988 and 1.4 percent in 1992.

These budget projections are contingent on CBO's forecast of a moderate pickup in economic growth from its subdued pace in 1986, and a modest decline in both short-term and long-term interest rates over the projection period from their average levels in 1986. They also assume that

both defense and nondefense discretionary appropriations are held to zero real growth. The budgetary outlook and the economic assumptions underlying the forecast are presented in Table 1.

The economic expansion has now entered its fifth year. Over the four quarters of 1986, the economy grew at a 2¼ percent rate--about the same as in 1985 but substantially below its growth in the first two years of recovery. Unemployment in 1986 was slightly below that of 1985 but still averaged 7.0 percent. Total employment grew rapidly, however, by about 2.3 percent. Most of the new jobs were in the service-producing sector. Growth in employment in the goods-producing sector continued to be weak, which is at least partially attributable to the widening trade deficit. The trade deficit was, in turn, partly the result of the high budget deficit. The latter has necessitated a large amount of borrowing from abroad, which has pushed up the value of the dollar until recently and made it more difficult for U.S. producers to compete with foreigners.

Inflation decreased in 1986, especially as measured by the Consumer Price Index (CPI), largely because of the precipitous decline in oil prices at the beginning of the year. Despite the continuing depreciation of the dollar against most other currencies, prices of imports did not move up as sharply as many forecasters had anticipated, nor did the import surplus decline as had been expected. Interest rates--especially long-term rates--fell considerably as a result of the easing of inflation, the sluggish growth of the economy, and the expectation of lower federal deficits.

TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

| | Actual 1986 a/ | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 |
|---|---|---|---|---|---|---|---|
| **Budget Projections (By fiscal year, in billions of dollars) b/** | | | | | | | |
| Baseline Estimates | | | | | | | |
| Revenues | 769 | 834 | 900 | 962 | 1,050 | 1,138 | 1,220 |
| Outlays | 990 | 1,008 | 1,069 | 1,124 | 1,184 | 1,247 | 1,305 |
| Deficit | 221 | 174 | 169 | 162 | 134 | 109 | 85 |
| Deficit Targets | 172 | 144 | 108 | 72 | 36 | 0 | n.a. |
| Baseline Less Targets | 49 | 30 | 61 | 90 | 98 | 109 | n.a. |
| **Economic Assumptions (By calendar year)** | | | | | | | |
| Nominal GNP (percent change) | 5.4 | 6.0 | 6.9 | 7.2 | 7.4 | 7.0 | 6.8 |
| Real GNP (percent change) | 2.6 | 2.8 | 3.0 | 3.0 | 3.1 | 2.7 | 2.5 |
| CPI-W (percent change) | 1.6 | 3.5 | 4.3 | 4.3 | 4.3 | 4.3 | 4.3 |
| Civilian Unemployment Rate (percent) | 7.0 | 6.6 | 6.5 | 6.3 | 6.1 | 6.0 | 6.0 |
| Three-Month Treasury Bill Rate (percent) | 6.0 | 5.6 | 5.7 | 5.6 | 5.5 | 5.3 | 5.2 |

SOURCE: Congressional Budget Office

NOTE: n.a. = not applicable.

a. 1986 data for nominal and real GNP and the CPI-W are CBO estimates. The estimates do not reflect the actual data for the fourth quarter of 1986 that were released on January 22, 1987.

b. The baseline estimates and deficit targets include Social Security, which is off-budget.

CBO forecasts a moderate pickup in economic activity in 1987 and 1988. Real GNP is expected to grow just under 3 percent annually, which should bring unemployment down to an average of 6.6 percent in 1987 and 6.5 percent in 1988. Like most other forecasters, CBO anticipates that the trade sector will be the major contributor to the stronger growth.

CBO's forecast calls for a rise in reported inflation, between 2 percent and 2½ percent in 1986 (as measured by the implicit GNP deflator) to about 3.7 percent in 1987-1988. On the consumer level, CBO sees inflation rising even more sharply--from the artificially depressed rate of about 1½ percent in 1986 to almost 4½ percent in 1987 and 1988. The rise in inflation will reflect, among other things, somewhat higher oil prices and rising import prices caused by the falling dollar. Nominal interest rates in 1987 and 1988 are expected to stay at about their present levels.

Under these economic assumptions, CBO projects a sharp decline of the baseline budget deficit in 1987 and a further moderate reduction in 1988. About half of the expected decline in the 1987 deficit results from one-time factors, including an increase in revenues under the Tax Reform Act of 1986, asset sales, and shifts of outlays into adjacent years. After 1987, revenues under current laws are projected to grow at an annual rate of nearly 8 percent--slightly faster than GNP--while baseline outlays grow only 5 percent per year, which is substantially below the 10 percent annual growth rate experienced earlier in the 1980s and less than the projected growth in the economy (see Figure 1).

Figure 2 summarizes recent trends and the CBO baseline projections for the major categories of federal spending. Nondefense discretionary spending has been curbed most sharply, falling from 5.8 percent of GNP in 1980 to 3.8 percent in 1987. Spending for national defense was fed by sharp real growth in appropriations in the early 1980s, followed by small real cuts in the last two years. These cuts and the CBO baseline assumption of zero real growth in budget authority would put the defense share of GNP on a downward trend over the next five years. Under current law, entitlement spending should remain at a steady share of slightly below 11 percent of

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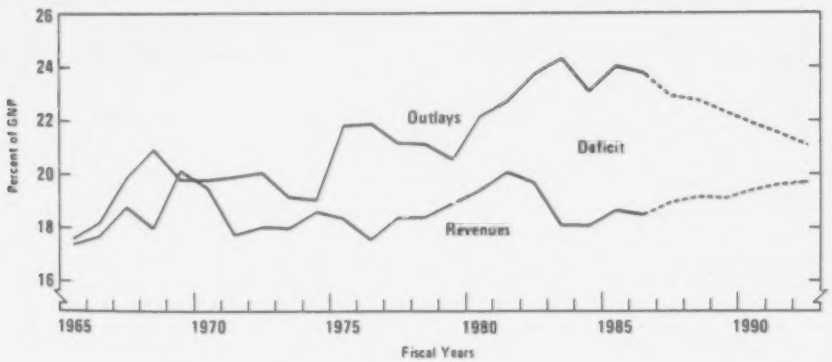
FIGURE 1.

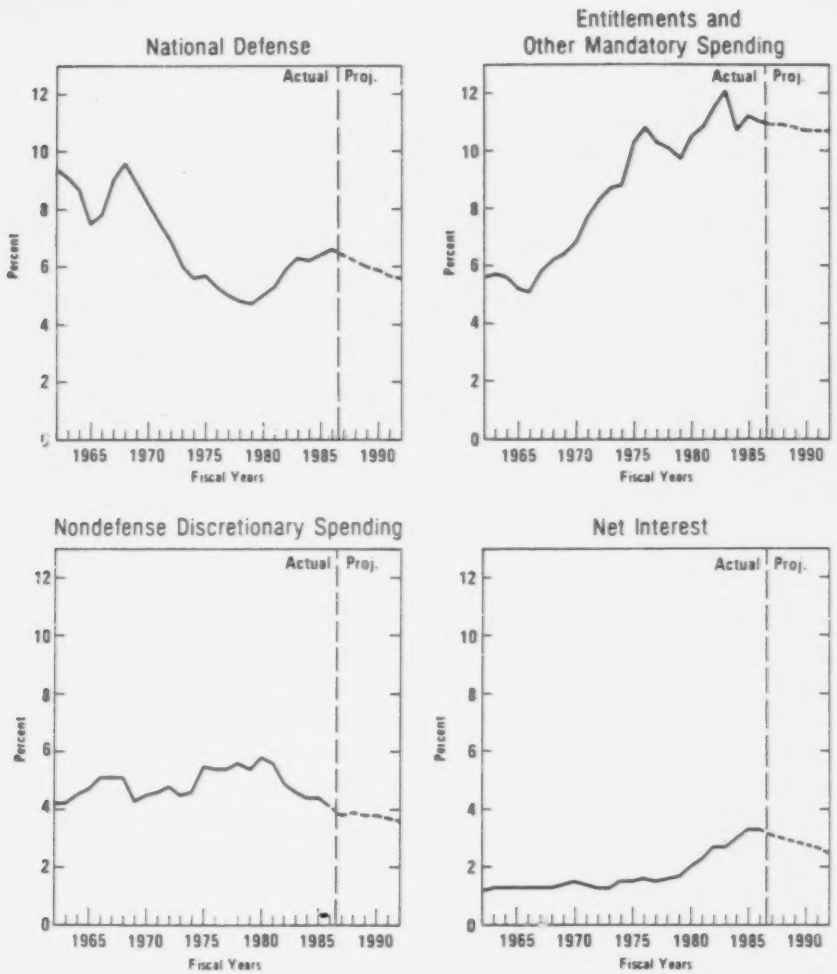
Baseline Revenues and Outlays




SOURCES: Congressional Budget Office; Office of Management and Budget; Department of Commerce, Bureau of Economic Analysis.

**FIGURE 2.**

## Outlays by Category as Percents of GNP




SOURCE Congressional Budget Office

GNP through 1992, although that category includes agricultural price supports, a notoriously difficult program to project. Price support spending has tripled in the last decade, and will continue to be affected by the weather and by foreign developments. Finally, net interest spending driven up first by rising interest rates and then by rising deficits should begin to fall as a share of GNP as these two factors are reversed. Any deficit reduction plan would most probably earn a bonus in the form of lower interest costs.

## DEFICIT REDUCTION OPTIONS

Baseline budget deficits, although declining throughout the projection period, exceed by large amounts the targets established by the Balanced Budget Act. The 1988 deficit would have to be cut $61 billion below the baseline in order to reach the goal of $108 billion. For fiscal years 1989 through 1991, the baseline deficit averages about $100 billion over the statutory targets (see Table 1).

Unless the target deficits under the Balanced Budget Act are amended, the budget resolution for 1988 will require the Congress to make exceedingly difficult choices to achieve reductions from baseline spending and additions to revenues. The 1987 version of CBO's annual volume entitled *Reducing the Deficit: Spending and Revenue Options* discusses these alternatives.

Spending Reduction Options

Making a major dent in the excess deficit by reducing government spending can, in theory, be accomplished in an infinite variety of ways. CBO's *Reducing the Deficit* volume attempts to present balanced, brief discussions of spending reduction options. We have divided spending into five major categories for this purpose.

- o National Defense
- o Entitlements Other Than Farm Programs
- o Nondefense Discretionary
- o Agricultural Price Supports
- o Federal Work Force

National Defense. This area of the budget supports developing and procuring equipment for the armed forces and paying personnel to operate and support their equipment. Budgetary savings for 1988 in national defense could be achieved in a variety of ways. Our report offers illustrative proposals for achieving savings in both investment spending and operation and support spending. Options for investment spending range from canceling major procurement items, such as the C-17 transport aircraft, to slowing production of programs like the Trident submarine and the MX missile. In the operating and support area, proposals range from limiting military pay to reducing the number of active-duty military personnel.

Entitlements Other Than Farm Programs. Social Security and Medicare are the two largest entitlement programs, representing almost two-thirds of nonfarm entitlement spending in 1986. The remaining one-third of this

category consists of other non-means-tested programs such as Unemployment Insurance (UI) and means-tested ones such as Medicaid. *Reducing the Deficit* includes 13 options that would slow the growth in spending for health programs, which has risen faster than outlays for nonhealth entitlements. Medicare is emphasized because it accounts for almost three-quarters of health spending in this category. Some of the alternatives would reduce payments to providers of health-care services, including revising payment rates for hospitals under the prospective payment system and introducing a fee schedule for physicians. Other options would raise receipts either by requiring that beneficiaries pay more or by increasing revenues from broad groups of taxpayers. The study also includes eight ways of modifying nonhealth entitlements that would cut the deficit. For example, the Congress could limit cost-of-living adjustments in Social Security and other non-means-tested programs or could change the benefit or revenue provisions of Unemployment Insurance.

Nondefense Discretionary Spending. About one-third of the spending on these programs provides individuals with benefits or services such as housing and education. Another one-fifth is spent on infrastructure systems such as transportation and water resources. The largest share--45 percent--is spread across diverse programs promoting business and commerce, civilian research and development, energy and natural resource development, aid to foreign governments and international organizations, and general government functions.

Budgetary savings in these programs could be achieved in a variety of ways described in this report. For example, education programs could be more stringently targeted toward students with financial or other special needs. Other options would increase the reliance on user fees and state and local resources, while improving the efficiency of transportation, water resources, the postal service, and other programs providing marketable services to private individuals. Savings could also arise by curtailing programs with uncertain or distant benefits--such as space exploration--or by reducing or redesigning programs where needs have changed--such as energy development.

Agricultural Price Supports. Federal spending on agriculture is dominated by supports for commodity prices and farm incomes. Such spending could be reduced while maintaining the current policy framework by further lowering target prices for supported crops or by allowing the Secretary of Agriculture to require farmers to idle more land as a quid pro quo for program benefits. A third option would restrict the ability of farmers to use generic commodity certificates (an innovation introduced in the 1985 farm bill) to repay their nonrecourse loans at prices below support levels. Alternatively, farmers in the most serious financial condition could be targeted for greater assistance, while commodity target prices are cut across the board for all farmers and crops.

The burden of supporting domestic agriculture could be shifted from the government to consumers by mandating reductions in crop supplies in order to raise crop prices. Finally, the current system of price and income supports could be replaced with direct grants to farmers that would be unrelated to their production and that would be phased out over time. This "decoupling" would support farm incomes for an interim period and allow crops to be produced and sold on their own economic merits.

Federal Work Force. Higher spending projected for this category derives mainly from pay increases and from the growth in retirement benefits received by former federal employees and their families. Reducing payroll costs, as indicated in two of the report's options, would require either curtailing the number of federal employees or changing the timing and size of government pay raises. The other options included in this section would lower health-care premiums for federal workers and their employing agencies, limit government travel expenditures, and restrict COLA payments for nondisabled federal retirees until they reach age 62.

Revenue-Raising Options

The Ways and Means Committee has just completed the herculean task of reforming our income tax system. This effort has reduced the number of loophole-closing options available for our report. Some opportunities for base broadening remain, however, and they are included. Outside of the income tax system, our report discusses a variety of excise tax increases (on energy, and so forth) and a value-added tax.

Since this is my last appearance as CBO director before this Committee, I would like to express my appreciation for the excellent relationship between CBO and the Ways and Means Committee and its staff. You have been one of our best customers, and I have enjoyed working with you.

Chairman ROSTENKOWSKI. Mr. Gibbons will inquire.

Mr. GIBBONS. Dr. Penner, I certainly hope that you are right; that these converging lines that we see on page 5 are correct.

How much of that depends upon action by Congress?

Mr. PENNER. None of it really depends on action by Congress, as we define it. On the outlay side, the line is based on current entitlement law, plus the assumption that the appropriations for discretionary programs are adjusted only for inflation. So that is, obviously, an assumption and not a forecast. On the revenue side, it is current tax law.

Mr. GIBBONS. So even if we did nothing other than stand still legislatively, by 1995 the budget deficit would be down to around what? $20 billion?

Mr. PENNER. I am not sure I would like to go out that far. By 1992, we had it down to about $85 billion, or 1.4 percent of GNP. I should emphasize that there is a lot of risk inherent in these projections. Relatively small errors in the forecast or the long-run economic assumptions could imply huge, huge errors in the numbers in table 1, on page 3.

We have done different scenarios. We did one which assumed a very serious recession starting soon; and then the deficit got up to over $200 billion. I think $266 billion, was our peak deficit.

On the other hand, if you assume that we miraculously return to the kind of growth we had in the 1960's, you would actually see a surplus out there. So these are very tenuous projections, and there is no room for any risk in them.

Mr. GIBBONS. How much more favorable are the administration's projections for the next few years than the projections made by CBO?

Mr. PENNER. They are more favorable in a number of respects. Most importantly, I think, they assume a higher rate of real economic growth and a bigger fall in unemployment. There are also technical differences. Assumes lower health costs, for example, than we do; and there are a variety of other areas in which we would be lower than them, farm price supports being one of them.

Mr. GIBBONS. How much of the trade deficit is attributable to the fiscal deficit?

Mr. PENNER. That is an extremely difficult question to answer, sir. You can create theories in economics where it is almost one-for-one; that is to say, a dollar increase in the budget deficit would lead to a dollar increase in the trade deficit.

I don't think I would go that far, myself, but I think that it is at least revealing how closely the budget deficit and the trade deficit move together step by step.

There are all sorts of other things that influence the trade deficit, obviously. But I think the biggest thing that changed in the early 1980's was the budget deficit; and, of course, at the same time we had the dramatic change in the trade deficit.

Mr. GIBBONS. Well, I have heard figures as high as 100 percent. As you say, you think that is too high?

Mr. PENNER. Yes.

Mr. GIBBONS. Then there are some people who say there is no impact of the fiscal deficit on the trade deficit.

Mr. PENNER. My own judgment is it is a lot closer to 100 percent than to zero.

Mr. GIBBONS. Well, if we accept it, is that a general consensus of economists throughout the United States?

Mr. PENNER. The old joke is that you can get five opinions from any four economists. So it is hard even to talk about consensus. But I would guess it would be a position favored by a majority of economists. They might not go quite as far as I have, and they might explain the linkage a little differently than I would. But I think it is fair to say that it is a consensus.

Mr. GIBBONS. Let me ask you—I don't ask you to do it right now; perhaps you could supply it to me privately or put it in the record—if we wanted to read more on this subject of the linkage of the fiscal deficit and the trade deficit, what sources should we go to?

Mr. PENNER. We can think about that, sir. There is a great deal of very highly technical work which you wouldn't want on the issue. But let us think about that and see what we can come up with.

Mr. GIBBONS. Thank you, Mr. Chairman.

Mr. PENNER. We did do an analysis, Mr. Gibbons, which tried to break out the extent to which the growing trade deficit could be explained by the rising dollar, by the difference between our growth and foreign growth, and by the fact that the LDC's have so much debt that they have greatly had to reduce their purchases from us, which, by the way, is a reason for the trade deficit aside from the budget deficit.

Mr. GIBBONS. Yes.

Mr. PENNER. What that doesn't really tell you is how much of the rising dollar can be attributed to the budget deficit. But we would be glad to supply that analysis to you.

Mr. GIBBONS. I would like that.

Could you ask your staff to send me over a package of that material?

Mr. PENNER. Yes, sir.

Mr. GIBBONS. Thank you very much.

[Mr. Penner subsequently submitted the following material, which has been retained in the committee files:]

EXPLANATION OF THE CAUSES OF THE TRADE DEFICIT

(1) CBO Staff Memorandum: "Analysis of the Deterioration in U.S. Trade Performance", March 30, 1984, response to request from Senator Chiles.

(2) Brookings Workshop on the U.S. Current Account Imbalance: "The U.S. External Deficit in the 1980s: An Empirical Analysis", by William L. Helkie and Peter Hooper, International Finance Division, Board of Governors of the Federal Reserve System, December 1986.

BUDGET DEFICITS—TRADE DEFICITS LINKAGE

(1) Excerpt from CBO's August 1985 report, "The Economic and Budget Outlook: An Update."

(2) Excerpt from CBO's February 1985 report, "The Economic and Budget Outlook."

(3) Testimony before the Committee on the Budget, United States Senate, January 28, 1987.

(4) The Wall Street Journal editorial, "The Results Are In on the Deficit Experiment", by Lawrence H. Summers, February 20, 1987.

Chairman ROSTENKOWSKI. Mr. Duncan will inquire.

Mr. DUNCAN. Thank you, Mr. Chairman.

Dr. Penner, the CBO states that its forecast is consistent with a 10-percent decline in the value of the dollar between the end of 1986 and 1988.

Are the recent declines in the dollar since January of 1987 consistent with your forecast?

Mr. PENNER. They have gone beyond our forecast. Our forecast rested on an assumption of about a 5 percent decline in the dollar per year. I think we are already at the level that we anticipated for about the middle of 1988. So the recent very sharp decline did catch us by surprise.

Mr. DUNCAN. If you were doing or redoing your forecast today, would you change your assumptions regarding the value of the dollar? If so, how would it affect the rest of your forecast?

Mr. PENNER. It would, I think, mainly affect the inflation rate forecast. We would add a little bit to the inflation rate if we expected this level to continue. It may not, of course. I think it would not probably affect our trade balance forecast.

We have considerable improvement there in our forecast. Despite the effect the recent decline in the dollar may have had on the trade balance—it works with long-time lags, of course—trade balance so far looks to be coming along about as we forecasted.

Mr. DUNCAN. Doesn't the economic forecast underlying your budget projection assume that the Gramm-Rudman deficit targets will be achieved?

Mr. PENNER. Yes, sir. We did the following: Because of the experience last year, we thought it unrealistic to assume that the target would be hit precisely. So, in doing our forecast, we assumed that the Congress takes advantage of the $10 billion margin of error; that is to say, it aims for a deficit of $118 billion. We almost assumed that not all of the fall from $169 billion to that number is real; that, as last year, there is some sale of assets and the like, amounting to $10 billion.

In terms of real cuts, we rather arbitrarily just assumed across-the-board cuts in spending, and increases in taxes, amounting to about $41 billion.

Mr. DUNCAN. If we did nothing or we just followed the spending and revenue assumptions in your baseline would it have a significant impact on your economic forecast, particularly on interest rates?

Mr. PENNER. I think it would have some impact, yes. I suspect that it would be disappointing to the markets and would, therefore, result in some increase in interest rates. I think, however, the problems would probably begin to show up beyond the end of our forecast period, which is the end of 1988.

Lack of action on the deficit would imply a continued high level of borrowing from abroad. That would be very risky. I am not saying it would necessarily change our forecast, but it would mean that we were relying on those international credit sources, with the risk that they could just get tired of this. They could just say that they have enough dollar assets and sort of go on strike. That would be a very serious matter for the U.S. economy, because as much trouble as the in-flow of foreign capital has caused—with its coun-

terpart, the trade deficit—we would have been much worse without it. I think you can say that.

So I would characterize lack of action not so much as something that would affect the forecast dramatically in the short run; it would affect the long-term rate of growth of the economy beyond the end of our forecast period in 1988. But most important, it would just create enormous risks for the economy in the future.

Mr. DUNCAN. Thank you, Dr. Penner.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Jenkins will inquire.

Mr. JENKINS. Mr. Chairman, I have no questions. I just want to thank Dr. Penner for being before the committee again.

Thank you.

Chairman ROSTENKOWSKI. Mr. Flippo will inquire.

Mr. FLIPPO. Thank you, Mr. Chairman.

I, too, want to thank Dr. Penner for being before the committee, and I have no questions.

Chairman ROSTENKOWSKI. Mr. McGrath will inquire.

Mr. MCGRATH. Thank you, Mr. Chairman.

Dr. Penner, I just have one question. Would the addition of revenue enhancers proposed by the President, or an oil import fee, as some Members of Congress have proposed, have any significant effect on figure 1, on page 5 of your report, in terms of baseline revenues, outlays and the deficit in 1990?

Mr. PENNER. Yes, sir. The President's proposals would have a very significant impact. While it is our judgment, as the chairman said in the beginning, that if you adopted all of the President's proposals you would still have a deficit—let's say around $140 billion, somewhere, roughly speaking, that would be a lot better than the $149 billion that we have in our baseline. And many of the proposals made by the President would not only reduce the level of spending and revenues, but would affect the slope of those two lines.

We have not yet had a chance to evaluate those proposals in the longer run, but most importantly they would bring those two lines together.

Mr. MCGRATH. Thank you.

Chairman ROSTENKOWSKI. Mr. Donnelly will inquire.

Mr. DONNELLY. Thank you, Mr. Chairman.

Dr. Penner, you will soon be leaving Government service, and we all appreciate the work you have put in in behalf of the Congress and your country. But you also then will have the opportunity to maybe speak a little more freely, unshackled from the restriction of being an employee of the Congress.

Let me ask you this: Do you think it is possible over the period of the next 5 years to balance the budget without a substantial increase in revenues——

Mr. PENNER. Well——

Mr. DONNELLY [continuing]. Over and above what has been recommended by the administration?

Mr. PENNER. That is truly a political question as opposed to being a technical question. Technically, of course, you can slash Social Security; you can slash defense. I don't have to explain the difficulty of the politics of that approach.

I think that there are few people, however, who have no revenue increase in their recommendations. Obviously, the President has some. It is a matter of how much. That, as I say, is really a political or ideological question because the answer to it depends on how you feel about what the Government is doing right now.

If you are happy with what it is doing right now, then yes, you will want a tax increase. If you think it is doing too much right now, then you will concentrate more on cutting the spending side.

Mr. DONNELLY. We are going to bring you back in a year, and I am going to ask you that question again.

Mr. PENNER. I think I can only answer it as a private citizen with an ideological package on my desk, as it were.

Mr. DONNELLY. Let me ask you about the pros—your opinion, personal or professional—the pros and cons of the VAT tax as a means of raising revenue?

Mr. PENNER. That is actually one of the options that we have in the book. As you can see from looking at it, you could raise huge amounts of money with fairly small, fairly low tax rates.

I think when you analyze a particular tax, it is best to compare it to some other tax for a basis. As compared to, say, raising the income tax, the VAT would be more conducive to saving because most VATs concentrate on consumption.

A VAT, under the rules of GATT, tends to be more conducive to trade, as well, and is applied to imports and rebated on exports. I think those are the attractive features of the VAT.

As for the unattractive features, some object to the distributional effects of the VAT, although as we show in our report, you can exempt necessities. Or if you decide to tax necessities, you can add to welfare payments to compensate. We have both packages in the report.

But some people, nevertheless, would still object to the distributional effects. The VAT would very likely have a short-run effect on inflation, although that is not certain.

Third, it is a brandnew tax and therefore would involve a whole new set of collection procedures, a whole new set of compliance requirements, and they should not be underemphasized. While in pure theory a VAT with no exemptions should be easy to administer, with due respect I suspect the Congress would put a few complexities in it. The more exemptions you have in it, the more different rates you have, and the harder it becomes to administer—at a greatly increasing rate.

In Europe, it is common to have a lot of exemptions. So you are talking about a lot of new revenue agents, with a lot of new compliance requirements. That is the down side of it.

Mr. DONNELLY. In your report, you do an analysis of the oil import fee, and as I have read through you state that it would have a disproportionate effect on various regions of the country. You specifically state that the Northeast section of the country would bear a greater burden because of the enormous amount of imported oil that we use for home heating.

Is that statement a fact from your report?

Mr. PENNER. It is a statement of fact. We have, done some analysis of the geographical effects of it. The differences between regions

aren't overwhelming, but they go in the direction that you have described.

Mr. DONNELLY. Thank you, Mr. Chairman.

Mr. GIBBONS [presiding]. Mr. Levin is next on the Democratic side, and Mr. Gregg is next on the Republican side.

Mr. Levin.

Mr. LEVIN. Thank you.

Welcome, Dr. Penner. We will miss you.

Let me ask you about figure 1, because my guess is that people may read it very different ways, and that way you could be misunderstood. So let me ask you, recognizing your position--you are still very much in the public sector—what your message is, what your conclusion is? Is it one of complacency about the deficit, confidence—I have tried to put this in a gradation—concern, or alarm? What are you saying to us and to the American people about the deficit?

Mr. PENNER. Well, my method is pretty complicated. On the one hand, if we had drawn that same picture on the basis of our projections of 2 years ago, the two lines would have widened. They were going apart steadily. I think the Congress should take some credit for bringing them together a little bit—but not too much credit, because we still have an enormously serious problem.

Maybe one way to put it is that my speeches about the deficit used to be filled with gloom and doom. They are not filled with gloom and doom any more—only gloom. The numbers implied by that spread are very big. A $169 billion deficit for 1988, while a lot better than the $249 billion projection we had 2 years ago, is still an enormous number, by historical standards. It implies an enormous reduction in American wealth, whether showing up as a fall in investment in this country or as a debt owed to foreign countries. It is very risky.

One of the reasons that we have been able to tolerate it, as I said to Mr. Duncan, is that we have been fortunate that people operating in international capital markets have been willing to lend us this money. What we have proved is that you can live very well on borrowed money. We all know that.

The question is: How long will we be able to draw on that source of money? The numbers between those two lines imply—and our overall forecast implies—a willingness of international capitalists to add to their holdings of dollar-denominated assets at a tremendous rate. We are assuming that that can go on.

But this is a feature of our projections that I worry about a great deal, because if the lenders went on strike, if they said they have enough dollars, and if the dollar then plummeted even more than it has in the last few days, you would most certainly get a rise in interest rates. That would happen for two reasons: a source of capital would be drying up, and the Federal Reserve System would probably feel the need to defend the dollar and raise interest rates further. So you would have a double-whammy, and it could indeed cause a recession. This is not something we are forecasting; I want to emphasize that. But it is a risk, a risk that is high and that you have to worry about.

I should also emphasize that there is no room in these projections for any new spending initiatives. An international crisis that

induced us to raise defense spending again would cause those two lines to separate. Any sort of national crisis that we felt required the spending of money could change the projections back toward where we had them two years ago.

So I think there is absolutely nothing to be satisfied with here except for the fact that the pictures is quite a bit better than it was in the recent past.

Mr. LEVIN. Thank you. That is a graphic answer.

Let me ask you quickly about the economic assumptions. We went over these with Dr. Miller yesterday and we pointed out to him the large gap between the estimates of the deficit and the reality at the end of the year. He attributed them mostly, or really entirely, to the fact we didn't pass their budget.

I don't want you to get into a fight here, unless you want to—I know you won't—but let me ask you: As you know, you have seen the Senate budget charts that show that OMB's mis-estimates of the deficit, because of the changes in economic and technical assumptions in 1985, was $17 billion—your mistake less—$33 billion in 1986, and $53 billion in 1987. Each year you were closer to the mark. In view of that record, why should there be any confidence in the estimates for 1988 and thereafter?

The last 3 years have been considerably off. Why is 1988 and the outyears likely to be so much closer to the mark?

Mr. PENNER. Well, I wouldn't claim it will be, sir. I think—I don't know how far back you want me to go in answering this question, but I think it is a fundamental problem with the budget process, one that has been intensified greatly by Gramm-Rudman; that it depends on estimates of budget totals, or rather that it demands more precision in those estimates than any economist can deliver.

If we forecast outlays within 1 percent, I think we have done a magnificent forecasting job. That is better than our average. One percent of a trillion dollars these days is $10 billion. If we have a 1-percent error on outlays, and a 1-percent error in revenues that goes in a different direction, we have got a $20 billion error in the deficit outcome—a trivial mistake, as economists define "mistakes," but a matter of immense political importance because of the extraordinary difficulty of finding $20 billion to cut from a budget.

So we are victims of the fact that we are trying to forecast these two huge numbers, outlays and receipts. The Congress is more interested in the difference between them, which is the deficit, and that thing jumps all over the place.

Another way to put it is that the difference between us and the administration with regard to outlay and receipts estimates, given current law, is less than 2 percent. As you wind your way through the Gramm-Rudman arithmetic, that difference results in an 80-percent difference in how much you have to cut to achieve the target.

So, if you are asking me am I confident of these numbers, I am confident we have done the best job we can. Because of the chart you see before you, we have been asking ourselves: are there some inherent optimistic biases in what we do? I think there are some. It is very hard to get away from them. They start at the level of the

very lowest analyst and work their way through the top. But we sure try to avoid them.

But a difference of $20 billion is not significant from an estimating point of view. It is part of the statistical noise.

Mr. LEVIN. Thank you.

Mr. GIBBONS. Thank you very much, Mr. Levin.

Mr. Gregg; and next after that, Mr. Coyne.

Mr. GREGG. Thank you.

I was interested in your analysis of the budget deficit in relationship to the trade deficit. Which comes first? You said that you felt there was a direct relationship between reducing the budget deficit and reducing the trade deficit. Is it necessary to reduce the budget deficit before the trade deficit can be reduced?

Mr. PENNER. I think so, sir. But that, in itself, is a forecast, because there are obviously other things that can affect the trade deficit quite aside from the budget deficit. I think if you look at the recent past, however, the thing that has changed most in our national life from a policy point of view has been the budget deficit. It has soared. It has been the one really strong change which I think has worked its way into the trade deficit.

That direction of causality need not exist for all time. There are various ways the trade deficit could be brought down, including having a big recession in this country so we could afford to buy less from abroad. But I don't think any of us would want to do it that way.

So, in terms of beneficial ways of doing it, I think that the budget deficit is really one of the few options we have for pressuring the trade deficit in the right direction.

Mr. GREGG. Can I characterize you as sort of adopting what I would refer to as the "Frenzel doctrine," which is that you cut the deficit, and as a result of cutting the deficit you impact the trade deficit, as versus going the other route, protectionism, to get to the trade deficit?

Mr. PENNER. I think that in terms of importance and good ways to do it, yes, sir, I am very much in accord with the "Frenzel doctrine." I hadn't heard it from Mr. Frenzel before, but it sounds good to me.

Mr. GREGG. On another subject, you have dealt now with the budget process for 5 years, I believe, as Director of the CBO, and we have seen what I will characterize as an obvious deterioration in the budget process. It has only been 6 years since I first came to Congress, and the budget process seems to have deteriorated rather radically in that time.

Could you pinpoint, if you accept my assumption that the congressional budget process has deteriorated, what you consider to be the primary cause of that deterioration and what might be the primary method correction?

Mr. PENNER. Well, sir, I would like to emphasize that while certainly the process is not perfect, and one could think of marginal improvements in it, I don't think the process is the problem. The problem stems from the fact that having gotten into this big budget deficit situation, all the options now are highly unpleasant. They all hurt somebody, whether you are talking about cutting spending or raising taxes.

There is no process known to man that could make those very hard choices easy. And they are choices which involve major changes in the way we do things, major changes in policy. After all, our revenues right now are covering only 83 percent of our outlays. That is a measurement of the amount of structural change we have to undertake.

I think the formal budget process itself was designed for and worked fairly well for a situation in which we were making marginal changes in national priorities. I think when you are making smaller changes, things are easy, and I think the traditional budget process, the 10-year-old budget process, has a lot to commend it in that regard.

I think, however, in the late seventies and early eighties we had a profound ideological debate in this country about the role of government, a debate that involved much more major changes in national priorities than we are used to, and the process could not respond to those pressures. I don't know if "breakdown" is too strong a word, but certainly as you say the orderliness of it has deteriorated considerably. It worked pretty well in the late seventies, I think.

Mr. GREGG. You are saying it is not a process problem; it is a political problem. But is there a process change which can assist the political apparatus addressing the budget issues?

Mr. PENNER. Well, I think there are things that you could look at. Again, I don't want to say they would contribute a lot to solving the problem, but I think many of us involved in the process see some advantages to a longer time horizon.

I am not sure that I would go to multi-year budgeting for the whole budget, but one proposal you might want to look at is one made by the Committee on Economic Development a few years ago in which we would evolve to a multiyear process by looking at areas of the Government which don't change much from year to year, aren't affected a lot by economics—things like the Bureau of Engraving and a whole bunch of offices, including ours, that go on much the same way every year.

It is not clear why we feel the need to appropriate every year, and in some cases even to authorize every year, for a very large part of the government. There are other proposals that I won't take a position on, but that you might want to look at. For example, Senator Quayle has one that would change the nature of the rescission process, that would probably very marginally enhance the power of the President compared to the power of the Congress. That may not be very popular, but it is one proposal one might look at.

But there are a series of others. Again, I wouldn't want to promise much from them. Nothing will make this problem easy. I think that is my main message.

Mr. GREGG. Thank you.

Mr. GIBBONS. Thank you, Mr. Gregg.

Next, Mr. Coyne. After Mr. Coyne, Mr. Ford or Mr. Pease, if Mr. Ford is not here.

Mr. COYNE. Thank you, Mr. Chairman.

Dr. Penner, last session of Congress the administration and Congress, and specifically this committee, attempted to pass a tax

reform that was revenue-neutral, and I think we did a fairly good job at that.

I was wondering if you have had a chance to review that legislation and determine whether that revenue neutrality is going to hold up, and what effect your projected figures are going to have on the deficit?

Mr. PENNER. Obviously, the concept of whether a bill is revenue-neutral is dependent on the economic forecast, and our economic forecast has changed. We have changed somewhat the timing of the losses and gains from tax reform. But it really is a change in the timing as opposed to a change in the amounts gained or lost over the whole 5-year period. For all practical purposes, you could still call it revenue-neutral according to our latest estimates.

Now, we are, of course, very nervous about it. We know about loopholes developing. You probably know about the problem with the estate tax, and so on, which is losing revenues. It is conceivable we could be hit by others of those kind.

As I say, we are nervous about it. But, from everything we know right now, one can still call the bill revenue-neutral, given these economic assumptions.

Mr. COYNE. Well, you state that it is revenue-neutral over the 5-year period.

Mr. PENNER. Yes.

Mr. COYNE. And some of the time projections would change.

Does that move closer or further away to being a deficit sooner or later?

Mr. PENNER. I think the main change in our estimates is that originally we saw a temporary gain of something over $11 billion in 1986, and we still see that. In the original estimates, that was to be followed by about a $17 billion loss in 1988. We now see a lesser loss in 1988 but a larger loss in later years. That is the most important single change.

Mr. COYNE. Thank you.

Mr. GIBBONS. Next is Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman.

Dr. Penner, I would like to begin by wishing you Godspeed as you leave your duties.

Mr. PENNER. Thank you, sir.

Mr. PEASE. I think you have served as Director of CBO with genuine distinction and could well be held up as a model public servant. You deserve great credit for what you have done with CBO.

Given your baseline deficit projection of $169 billion for fiscal year 1988, and $158 billion with the discretionary program freeze, what do you think the deficit target should be that Congress sets as its goal for fiscal year 1988?

In other words, there has been some concern that we could cut the deficit by too much. What would you suggest would be the proper target?

Mr. PENNER. The answer to that depends absolutely and crucially on how you would envision cutting the deficit. If one reflects back on the experience of 1987, one sees that about two-thirds—well, we estimated that legislation cut the 1987 deficit by $32 billion. Over two-thirds of that amount was the result of temporary factors—the $11 billion increase in tax revenues I mentioned

before, associated with reform; $7 billion in asset sales; $4 billion of what I will call creative timing differences.

So, if one contemplated cutting $61 billion from the deficit, and two-thirds of that amount was again temporary factors and gimmicks of one kind or another, there is no economist in the world who would say that it would be dangerous in any way, because these temporary things have no real effect on the economy. Moving the military payday one day had no real effect on the economy. So, in that kind of framework, there would be nothing to worry about.

Our own assumption that led to this economic forecast was that you would go to $118 billion, and $10 billion of the cut would be of a temporary nature. So, in other words, that involved a cut of $41 billion, essentially.

Again, if you think our forecast is okay, there is no obvious problem. Obviously, as you go on, you tend to shock the economy more and more.

I think everybody agrees the deficit reduction is fine and very good in the longer run. There is some short-run shock attached to it. But I don't think that the risks really start to increase until you get beyond, say, 1 percent of the GNP, which would now be about $47 billion.

I guess what I would suggest, having witnessed the experience of last year, is that if you are contemplating changing the targets, you should simultaneously contemplate changing the definition of the target so as to close off some of the most egregious opportunities to use smoke and mirrors.

We have a suggestion in our annual report about a different way of handling loan asset sales, for example, which would not count them as deficit reduction, but, rather, count them as a means of financing the deficit. I think that that is much more sensible from an economic point of view.

Obviously, selling an export-import bond to the credit markets draws on savings in almost exactly the same way as selling a Treasury bond. So we have some suggestions in that regard, and obviously think they should be looked at if you were changing things around.

Mr. PEASE. So essentially you would recommend generally sticking with the Gramm-Rudman deficit reduction targets; is that correct?

Mr. PENNER. I don't make recommendations. But what I am suggesting is that, from an economic point of view, if a large part of what we would define to be a $61 billion cut is of the nature of asset sales and other temporary factors, I don't think that one can say there is a big economic shock involved.

Mr. PEASE. We are now into the fifth year of a rather long recovery. It is very unusual for a recovery to go this long. Your predictions or forecasts for the next couple of years are for continued economic growth, that is to say, no recession. How much of a danger do you think there is that the law of averages will catch up with us and that we will have a recession sometime in the next couple of years which could dramatically affect these forecasts?

Mr. PENNER. There is always some risk of that, but while you are correct that this is one of the longer recoveries on record, it also

started from a much deeper recession, in fact, the deepest recession in the post-war period.

Expansion has recently been very slow. While there are a few economists forecasting recession, it's very hard to see strains developing in the economy that will usually lead to recession. Wages have been very well behaved.

Industrial capacity utilization is low. Commodity prices have been well behaved. Some external factor like an oil shock or some other shock that could drive us into recession, but given what we know, I think the probabilities are really pretty low right now.

Mr. PEASE. Thank you.

Mr. GIBBONS. Next is Mr. Brown; after Mr. Brown, Mr. Pickle. Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Dr. Penner, it's nice to see you again. I seem to follow you around from the previous committees on which I have served. I would like to follow up on some issues just recently broached. Your summary notes that we are in the fifth year of an economic expansion, and that that is a fairly long time for an economic expansion. I note in your forecast you indicate that the most likely scenario is for another 5 years of continuous economic expansion.

Mr. PENNER. Let me just amend that, sir. We try to differentiate between our forecast, which goes through the end of 1988, and where we do not see a recession, and out beyond that we simply project very modest rates of growth compared to past history, and we would anticipate some cycle out there. That is to say, there could be a mild recession, but we would expect that to be offset by years of above-average historical growth.

So, we are really just saying that is our guess, assuming average growth. I think it would be preposterous to claim we know when cycles are going to start and finish out there. We don't even fully understand what happened last month, let alone what may happen in 1988.

Mr. BROWN. So your position is not that a recession is unlikely throughout the 5-year period?

Mr. PENNER. No. But these estimates could only accommodate mild recession. We do have a scenario with a very serious recession along the lines of 1974, 1975, and that leads to a huge increase in the projected deficit.

Mr. BROWN. Well, I noticed that a recession would result in a deficit of about $266 billion, if I read your report correctly.

Mr. PENNER. That is correct.

Mr. BROWN. And the deficit would increase to $278 billion the following year in the event of a recession. If I recollect, your report's comparison of the first budget resolution, the actual deficits over the last 7 years, show that there was not a single year when the deficit wasn't higher than the deficit assumed in the first budget resolution.

Wouldn't you say that is a pattern of continuous failure, not only of forecasting but of budget discipline?

Mr. PENNER. Yes, sir. It is a combination of a variety of things. We have actually summarized this experience. Do you have our annual report? It's on page 145. It shows you what went wrong. Now, for self-protection, I should hasten to say you haven't always

used our forecast. Indeed, you rarely use our forecast without some modification.

So although, as I said, I think we probably have some optimistic bias, it's not quite as large as these numbers would imply. But you can see the problem. You can see how far you have departed from the legislative assumptions and you can see the economic and technical errors.

But you are right. It is, I think, uniformly an optimistic bias.

Mr. BROWN. Dr. Penner, is there anything you could tell us about the potential of interest rates returning to much higher levels than are projected in your more pessimistic scenario?

I am referring specifically to the prospect of having to finance a large portion of our deficit overseas, combined with the falling dollar and the fact that potential foreign lenders may no longer be willing to finance our debt as readily as they have in the past.

Is there some chance we will see dramatically higher interest rates as a result of these combined factors?

Mr. PENNER. I think it's important to differentiate between nominal interest rates and real interest rates. Nominal interest rates, of course, could go up with inflation. We see some increase in inflation over the next 2 years. We think it's a result of temporary phenomena, the disappearance of the oil benefit and the fall in the dollar. That in itself puts upward pressure on nominal interest rates.

We, in our forecast, do not have nominal interest rates going up as much as inflation because we assume that the progress on the deficit that we see in our baseline will reduce real interest rates somewhat. You start with real interest rates at really a very high level compared to the rest of our postwar history.

So we see the deficit coming down, returning generally to more historical levels. You are right in your description of the risk involved. Our forecast, and even our longer term projections, assume that we will continue to be able to draw on international capital markets to finance the deficit. If that should go awry for one reason or another, then certainly the real interest rate will rise. As I said before, it would rise not only because of a reduction in the inflow of savings, a sort of supply and demand phenomenon, but also because the Federal Reserve System would probably feel the need to defend the dollar under those circumstances, thus raising real interest rates further.

Mr. BROWN. Thank you.

I yield back the balance of my time, Mr. Chairman.

Mr. GIBBONS. All right. Fine. Next is Mr. Pickle and after Mr. Pickle, Mr. Rangel.

Mr. PICKLE. Thank you, Mr. Chairman.

Dr. Penner, it's good to see you. We are sorry you are leaving but you rendered a great service.

Mr. PENNER. Thank you.

Mr. PICKLE. The point I want to emphasize first is you have stated, according to CBO, that the President has underestimated the deficit by nearly $28 to $30 billion. I have to take that as a fact of a sharp difference between what CBO has said and what the President's staff has said.

Is that basically correct?

Mr. PENNER. It is. It's a difference in forecast of a very uncertain world. I am not saying that.

Mr. PICKLE. I understand. Your position is that we are still underestimating the deficit by some $28 to $30 billion.

Mr. PENNER. By that order of magnitude, yes.

Mr. PICKLE. You have said we are trying to approach the $108 billion deficit, according to Gramm-Rudman. Mr. Donnelly or someone had asked you can we achieve $108 billion level without any increase in taxes and you said, well, theoretically you could do it. But I take that to mean that you said that "technically" we could, but realistically probably not. Is that basically correct? We are probably going to be faced with the choice of some kind of revenue raiser?

Mr. PENNER. Well, as I said, I think the dispute now has turned to how much. Even the administration has revenue raisers in their recommendations. So the issue is how much. As I said before, I think that is a purely political question.

Mr. PICKLE. Let me pursue that a minute. When we passed Gramm-Rudman, we made a political decision that over a period of 5 years we are going to make certain reductions in increments that will give us no deficit in 5 year's time.

Now, that was a political decision. Congress supported it, I supported it. I think we ought to try to adhere to that. Now, Dr. Penner, that was a political decision. You are an economist, a professional economist. The real question is should we stay strictly with that or, as an economist, do you think we have to take some other changes in addition to Gramm-Rudman?

I know you are going to speak now as an individual but I want you to, if you will, from an economic standpoint, speculate on what we should do.

Mr. PENNER. I think in the long run there is a broad consensus among all economists, or most economists, that it is very important to get this deficit down for the sake of our children and grandchildren.

We are in the process of destroying their wealth. We are on a big consumption binge. As you bring the deficit down, there are more differences among economists as to the short-run impact of bringing it down and there are differences of opinion about how fast you should bring it down. I said before——

Mr. PICKLE. I know there is a difference of opinion. I'm asking you your expert opinion. Economists are divided on it, I know.

Mr. PENNER. As I said before, how you bring the deficit down is really just as important as how much you bring it down. If it's brought down in the fashion that the 1987 budget deficit was brought down, then, in my professional judgment, there is no problem with the Gramm-Rudman targets. If it were to be brought down by $61 billion in real dollars, there would be some risks. We talk about that in the report—we call them risks because some economists would say that would be a really big shock.

Mr. PICKLE. If we did have some normal revenue raisers do you think that's properly bringing the deficit down?

Mr. PENNER. I'm sorry, sir? Could you repeat that?

Mr. PICKLE. If we make a sharp increase in revenues, that might be too much too quick. But if we just try to close the gap with reve-

nues now to bring the deficit to $108, do you think that would be too much of a shock? My question is, should we also consider some revenue raisers to hit that $108 level?

Mr. PENNER. I'm not sure I fully understand you, but if you brought the deficit down all on the tax side, and those taxes were long-lasting taxes that would become a permanent part of our structure, it would be quite a big shock to the economy.

Mr. PICKLE. Suppose we did it not just by taxes but by a combination, a good balance between spending cuts and revenues? Would that be a proper approach to take?

Mr. PENNER. It could be. Again, I emphasize the question of whether the policy changes are really long-lasting, true, permanent changes in the deficit as opposed to what was done last year. To the extent they are not permanent, then there is no worry. But if they really are permanent, then as we say in our report, there might be some risk.

Again, I would like to repeat the suggestion I made before that if you are contemplating changing the target it would probably be useful to contemplate at the same time creating an incentive for those deficit changes to be real deficit changes. We have made some suggestions in that regard.

Mr. PICKLE. Doctor, you said we could make certain reductions. One was in the area of national defense and you listed some options where we could make our reduction. One of them was postponing the decision on the C-17, the Trident submarines and MX missile. I would like you to submit for me—it may be in your report—how much would we save if we delayed the C-17?

We have another controversy on the floor, the T-46. Should we proceed with it or not? Do your books show how much would be saved through either the C-17 or the T-46?

Mr. PENNER. You said delay the C-17. We discuss outright cancellation in this book and say it would save $690 million in outlays, rising to $2.3 billion by 1992. I don't think we have the T-46.

Mr. PICKLE. Do you have the T-46? I understand the Air Force did not recommend that but it was still put in, just for a savings estimate.

Mr. PENNER. The President does not recommend the T-46, so there would be no saving relative to his budget by cancelling it.

Mr. PICKLE. We need to get for the record just what the T-46 would cost overall.

Mr. PENNER. We can provide a copy of our staff working paper: "Alternatives for an Air Force Trainer: T-46 or T-37." The paper provides estimates of the total cost of the program and its alternatives.

[The paper was received and has been retained in the committee files.]

Mr. PICKLE. Let me ask you one last question.

You said we think the economy is going to go forward. You say this is so absent some big shock such as you said, "an oil shock." What do you call an oil shock, Dr. Penner?

Mr. PENNER. People who study oil markets, of course, are very concerned about the Iran-Iraq war. I think most of them would suggest that if Iran were to have a big military victory that it would probably raise the price of oil quite a bit.

Mr. PICKLE. If prices of oil went from say $18, what it is now, up to $40 a barrel that would be a quick, abrupt oil shock?

Mr. PENNER. That would certainly be a shock.

Mr. PICKLE. Do you think that is going to happen?

Mr. PENNER. I am not a military expert, but that is not what is in the forecast, no.

Mr. PICKLE. But oil is at $18 a barrel now. That is not any shock.

Mr. PENNER. No.

Mr. PICKLE. I note several members keep bringing up the question about an oil import fee. If we had the oil import fee that was requested last year it would have only brought the price of oil per barrel to about $20. It is almost the same level today that we had asked for and the country is improving. So it seems to me like all the horror stories about an oil import fee hurting the economy are red herrings. An oil import fee should be passed.

Mr. GIBBONS. Mr. Pickle, your time has expired.

Mr. PENNER. As an aside, Mr. Pickle, I might say that it looks like we may have been a little optimistic in our forecast. We had $15 oil throughout in our forecast. That may still come to pass, but it is lower than today's $18, obviously.

Mr. GIBBONS. I was on the committee when the chairman of Exxon told me if they could ever get the price of oil up to $3 a barrel, it would just be wonderful.

Mr. PENNER. Up by or up to?

Mr. GIBBONS. Up to $3 a barrel.

Mr. PICKLE. When was that, about 1940?

Mr. GIBBONS. No. That was in 1972 in room 2216 of the Rayburn Building at 3 o'clock in the afternoon. He had boots on.

Let's see. Mr. Frenzel and then after that, Mr. Rangel.

Mr. FRENZEL. Thank you, Mr. Chairman.

Thank you, Dr. Penner, for helping to inform us of the impending doom. I also want to thank you for your service at CBO. As you have discovered, it's not terribly remunerative, but you can make up in fun and excitement what you lose in permanent assets. It's been very good to have you there.

You said in response to a previous question that if the deficit targets were modified, one would want to be sure that the Congress does not engage in the same kind of scullduggery as in the past, and will, in fact, make some permanent cuts. What are your suggestions in that regard?

Mr. PENNER. I suppose I should admit right away that it's not possible to close all loopholes. There will always be some problems. But we think at the moment, one of the most serious problems involves the sale of loan assets. In our annual report, we have made a suggestion. We believe that the subsidies inherent in our credit programs should be clearly shown in the budget, but that the nonsubsidized portion of credit transactions, the capital portion as it were, should not. If you sell an asset, that part should not be recorded as a deficit reducer, but rather as a means of financing the deficit, just as would a sale of a Treasury bond. If you sell a loan held by the Export-Import Bank, it shouldn't be considered any different than selling a bond.

Mr. FRENZEL. It looks as though you have estimated the baseline deficit for fiscal year 1988 at approximately $170 billion.

Mr. PENNER. Roughly speaking, sir.

Mr. FRENZEL. Your estimate of the President's budget would put the deficit at what level?

Mr. PENNER. Well, I should say that this is a preliminary estimate. We only got all the details just a fairly short time ago. But as a preliminary estimate, if you adopted all of the President's policies, we are suggesting that the deficit would be somewhere around $17 billion, $32 billion higher than the $108 billion target.

Mr. FRENZEL. Since we have apparently missed last year's target by $25 billion thus far, it seems unlikely that we will achieve a much more difficult target this year. One might further speculate that if Congress understands how much it is going to miss Gramm-Rudman, there will be an effort to modify it in some way. A Congress which is unwilling to adopt a budget that hits the target is likely to be equally unwilling to have that target achieved through sequestration.

Therefore, it seems to me that there will be an effort to modify the targets. Further, it seems to me that if we really did what we were supposed to do and followed the Frenzel theorem of actually cutting spending, as you have suggested, the magnitude of reductions required to get to the Gramm-Rudman target will certainly be disruptive in some respects to the committee.

Have you thought about new targets? Have you provided any options publicly?

Mr. PENNER. No, sir, we have not done anything explicit in that regard.

Mr. FRENZEL. Do you share my belief that there is at least some likelihood of revision?

Mr. PENNER. It's certainly being discussed at every hearing I have been a witness at so far.

Mr. FRENZEL. In part 2 of your report you have some suggestions about revenue. However, the President has presented to this committee lots of options which don't fit your categories, for instance, many user fees.

Mr. PENNER. We have discussed those in another section of the book, sir, in the nondefense discretionary section.

Mr. FRENZEL. Do you?

Mr. PENNER. Yes, sir.

Mr. FRENZEL. I apparently missed that. Although it also seems unlikely to me that either your suggestions or the President's suggestions are going to be accepted since Congress has rejected most of the President's suggestions in the past and your options, at least under the revenue section, are tax options which the President seems sworn to veto.

So it looks as though we are where we have always been, realizing little success in reducing the deficit.

I hate to see you bow out under these circumstances. I thought we were going to solve all the problems during your tenure. In any case, again, let me say I am terribly grateful for the service that you have given to the Congress and I hope you get terribly rich in the next couple of years.

Chairman ROSTENKOWSKI. Mr. Andrews will inquire.

Mr. ANDREWS. Dr. Penner, in reviewing your spending and revenue options I am reminded of Bismarck's quote that "Politics is the

art of the possible." Some of your recommendations not only do not seem possible, but in particular, your suggestions to cancel space station development and possibly the additional orbiter, do not seem to be good public policy or prudent as well.

Mr. PENNER. I again want to emphasize, sir, these are not recommendations. I hope we have stated the arguments against these various things as well as we have stated the arguments for these various things.

Mr. ANDREWS. In your opening statement, you said that savings could arise by curtailing programs with "uncertain or distant benefits" such as space exploration. I wonder if you would elaborate on your view and tell me if that is CBO's view of the space program and where we are headed with the space station in particular.

Mr. PENNER. I think that wherever there is an uncertain payoff to a program, whether it be in technology or in labor or retraining or whatever, it has to be examined very carefully, and essentially that is all I am trying to say. That is one example where the rate of return could be huge, or it could be zilch. And we don't know. It's a question then of the Congress evaluating the risks. We can only say what they are. We can't say what the Congress should do about them.

Mr. ANDREWS. Surely if a conclusion were to be made by the Congress to kill the space station, and to a lesser degree, I suppose, to not construct an orbiter to replace the *Challenger* that we lost, not only would it be a major policy change in space exploration, it would literally stop the space program in its tracks.

I am curious what your view is of the revenue needs to reduce the deficit and meet the Gramm-Rudman targets as they relate to space. Where are we in terms of raising those dollars? Let me illustrate a point to my question.

This week the President announced his intention that Congress spend dollars to build an atom smasher. The cost of that atom smasher could be anywhere from $6 to $8 billion. In his announcement there was no suggestion made as to how it would be paid for. At the same time we are talking about a new program like that, there is a suggestion made to curtail the space station. I wonder if you would just give us your thoughts about the revenue requirements on new programs as well as important programs like the space station.

Mr. PENNER. I suppose it's important to point out that a very large number of these options really look like they involve small amounts of money. You obviously can't solve the problem with any small set of options, nor can you say that the increase in taxes to finance most of these programs that we talk about cutting would be an enormous increase in the tax bill.

We feel it important, however, to put in small options because that, in essence, is the way the Congress has proceeded over the last 5 years.

I mentioned that we had made a lot of progress. Nobody is very satisfied about the extent of the progress, but there have been changes. In fact, the whole nondefense discretionary category is absorbing less of our GNP than it did in the early sixties.

So you can see in terms of the trillion dollar budget, yes, the space station program runs between $400 and $500 million a year

in the CBO baseline. The space shuttle at its height, about $620 million. Again, in a trillion dollar budget, these are not enormous things. But when you add up a whole series of things like that, you are starting to talk about real money.

Mr. ANDREWS. Has CBO done a study of stretching out the space station? One of the debates that is ongoing now is the fact that we may have to stretch it out a few years in order to meet the Gramm-Rudman targets.

Mr. PENNER. We have not. We have not looked at that, sir.

Mr. ANDREWS. The same, my question would hold true with the replacement of the orbiter. Has your staff made any review of what kind of savings may or may not be achieved by stretching that program out a few years?

Mr. PENNER. We have done a study of it and we have done studies of pricing it. Stretching out—well, there are a lot of sub-options there. We have not really studied them or put dollar values on them. But, for example, with the space station, you could obviously have a less elaborate, smaller station than the one that is now envisioned. You could talk about delay and so on. If you have particular options in mind, we would be glad to take a look at them.

Mr. ANDREWS. I would like to visit with you about that at some later time. I think this issue of the station is just illustrative of the point that you have tried to make, Dr. Penner. The choices are very, very narrow now as we try to come to grips with this deficit. There are going to be many things that we would like to do on the spending side and won't be able to do because of lack of revenues.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Rangel will inquire.

Mr. RANGEL. Thank you, Mr. Chairman.

Dr. Penner, let me join my colleagues in thanking you for the contributions that you made to the Congress and the nation and wish you luck in your new endeavors.

Mr. PENNER. Thank you, sir.

Mr. RANGEL. Let me ask, as you economists project the deficit reductions and think in terms of options for spending cuts, is there any way in your shop you are able to ascertain what not only the social cost would be, but what the projected economic costs are as we see poverty expanding, lack of training leading to unemployment, high school dropouts leading to drug addiction, leading to crime, leading to the cost of imprisonment.

I recognize that many of these costs are local and State, but to a large extent, there is a relationship between poverty, unemployment and crime and there is a Federal responsibility.

I just wonder, is there room in your shop to evaluate these things when you are projecting the national cost?

Mr. PENNER. Well, there are different degrees to which you can do these kinds of things. The law requires us to make some judgment as to the cost imposed on State and local government when the Congress passes some new law, some new program. And we try to do that. Some of the linkages that you discuss are more clear than others.

Mr. RANGEL. Let me pull one out.

Mr. PENNER. Yes.

Mr. RANGEL. The cost of drug addiction—and I am not talking about the social cost of a human being not fulfilling his potential. I am just talking about the projected cost of a 15-year-old kid being addicted to drugs.

Mr. PENNER. We can do analyses, look at the research on that kind of issue and make some estimates. We do not, however, take into account those kinds of indirect effects when it comes to scoring a program, in terms of telling your committee what the outlays are for a particular piece of legislation.

Mr. RANGEL. Let me give another example. The cost of a person being unemployed, forgetting his potential, broken heart, kids dropping out of college, mortgage foreclosures, forgetting all of that, the economic cost of keeping this person surviving.

Mr. PENNER. Those kinds of costs are inherent in our projections because our projections assume a certain unemployment rate. That unemployment rate is used to forecast our outlays on a whole variety of things, including obviously unemployment insurance, but perhaps less obviously food stamps, even Social Security.

Mr. RANGEL. You say inherent, but where would we be able to use these things? If indeed we are going to accept your figures for unemployment and we are going to cut back in job training and/or cut back in food stamps, where can we pick up in your shop the inherent cost, say, of just poverty?

Mr. PENNER. Well, there are really two different issues. We can easily give you, and indeed, in our report here, we show on page 53 the effects on the budget of unemployment suddenly rising one percentage point, and you can see that that would imply a $36 billion increase in the 1988 deficit, with $6 billion of that being the kind of outlay effects I just described and $30 billion being the tax loss associated with the lower level of the economy.

We can break those numbers out in more detail as to particular programs, food stamps, et cetera.

Mr. RANGEL. Is there any office besides yours that focuses on this type of thing, as to what does it cost our nation when our poverty numbers are increasing? And including the local and State cost?

Mr. PENNER. Well, various academics, I think, have made different estimates of that. We do it on a more systematic basis, I suppose. But I should hasten to add, of course, the controversies start when you ask how do you change unemployment by 1 percentage point or how might you change the poverty rate or whatever.

It's a lot easier to look at the most obvious effects of those things than it is to say, you know, how they can be changed.

Mr. RANGEL. Well, Doctor, it may be more complicated for an economist than a social scientist, but you can go to any major city and take a look at the high school dropout and somebody should be able in dollars and cents to say what this person is going to cost society before he or she dies, either in teenage pregnancy, drug addiction, crime.

Mr. PENNER. The distinction I am trying to make is between trying to make an estimate of that—and you can certainly try to make an estimate of the things you are talking about—and trying to say exactly how you could have kept that person from dropping out in the first place. I think that is a different step of analysis.

Mr. RANGEL. Forget the first step. Where would I go to find out in broad, general terms, the cost of the dropout, the cost of the addict, forgetting what we could have done to prevent it? But with all of these problems, everyone says we should cut back in federal spending and domestic programs. I am for that, but where could I go to see what we will have to pay down the line if certain programs, designed to prevent further tragedies, are cut out? Would it be your shop? Would it be someplace you could direct me?

Mr. PENNER. I think there is a lot of research on that sort of thing. Two steps, as I say. One, what does the program do to the problem, first of all, and what does that cost, and then what are the social costs of the problem, social dollar costs. A lot of work is done on that sort of thing. We can refer you to some of it, I think.

Mr. RANGEL. Let me make it clear, I am not asking you to refer me to the programs that are designed to eliminate the problem. Because in many cases, we don't have a program. But if you could ask your staff to direct me to the agencies or the office that tries to put a dollar sign on the cost of a problem, it would be helpful.

Mr. PENNER. I think we are talking mostly about academic studies of one sort or another, sir.

Mr. RANGEL. Mr. Chairman, I would like to submit a list of questions that the staff have given me to give to the Director to be included in answers at some later date.

Chairman ROSTENKOWSKI. Without objection, so ordered.

[The questions and answers follow:]

**Question**

Many of the deficit reduction proposals that are in the Committee's jurisdiction are one-time savings, savings from proposals that have been previously rejected by Congress or savings that undo bipartisan agreements reached last year. Overall, what proportion of the $42.4 billion of savings in the President's budget for FY 1988 have been previously rejected by Congress? What proportion are savings which alter bipartisan agreements reached in the reconciliation bill of last year? What proportion are one-time savings?

**Answer**

According to CBO's estimate, the cut in nondefense spending and increases in revenues proposed by the Administration total $43.9 billion in 1988. Of this amount, $15.9 billion constitute one-time savings from asset sales and spending delays. It is not always possible to identify unambiguously those proposals which the Congress has previously rejected; in its published analysis of the President's budget, CBO has noted those proposal that have clearly been advanced and turned down in the past. Using its own criteria, the staff of the Senate Budget Committee estimates that $18.8 billion of the 1988 savings in the budget results from proposals previously rejected by the Congress.

**Question**

Yesterday, OMB Director Miller testified that he believed your preliminary analysis of the President's budget that the FY 1988 deficit target had been exceeded by $27 to $32 billion would be reduced when you better understand their budget. Is that true?

**Answer**

The Congressional Budget Office now estimates that the federal deficit under Administrative policies would be $134.4 billion in 1988. This amount exceeds the Balanced Budget Act target by $26.4 billion.

**Question**

What amount of the difference is due to policy changes that are embodied in OMB's current services estimates? For example, we understand that $1.4 billion of a $5 billion estimating difference in Medicare outlays is due to a policy change which would slow down the issuance of checks to hospitals. Is that correct?

Answer

The Administration's current services estimates include some spending delays that CBO's baseline does not. The two major instances are Medicare and farm price supports.

- In the Medicare program, the Administration assumes that reimbursements will be paid no faster than the law requires. The Omnibus Budget Reconciliation Act of 1986 establishes maximum time periods for payment of most claims. The maximum period declines from 30 days in 1987 to 26 days in 1988, 25 days in 1989, and 24 days thereafter. Data recently collected by the Administration indicate that current payments are already well within the guidelines. Therefore, the Administration's current services estimates imply a slowdown in payments. CBO does not assume such a slowdown, and this difference accounts for about $1 billion of the additional outlays in CBO's baseline.

- In agriculture spending, the Administration's current services projections exclude advance deficiency payments to certain producers of wheat, feed grains, cotton, and rice. Advance deficiency payments were mandated by the Congress for the 1987 crop year, and were paid in three of the four previous years. CBO's baseline includes advance payments of $4.5 billion in 1988, and slightly smaller amounts in later years.

These different interpretations of current policy do not affect CBO's reestimate of the President's budget. In our report (An Analysis of the President's Budgetary Proposals for Fiscal Year 1988), we identify such spending delays and show that they reduce the deficit, albeit temporarily.

**Question**

How likely is the low path for FY 1988? What fiscal policy would avoid it?

**Answer**

CBO makes alternative "high path" and "low path" economic projections in order to illustrate the extent of uncertainty in budget projections that is caused by uncertainty about the underlying economic situation. However, these do not, in CBO's view, represent highly probable outcomes, and we do not in fact think that a recession is likely in the next two years. Most private forecasters agree: Eggert Economic Enterprises reports that out of 46 forecasters responding to a recent survey, only 12 expected a recession of any sort to start before the end of calendar 1988. 1/ The probability of the CBO low path is substantially less than that of a recession, for two reasons:

- The recession depicted in the CBO "low path" is particularly severe, following roughly the same real GNP path as the 1973-1975 recession; and
- the "low path" recession is accompanied by a slowing of inflation relative to the CBO baseline economic forecast, whereas the 1973-1975 recession was accompanied by sharp price increases for oil and other commodities that tended to support the growth of revenues through the recession.

Recent economic indicators support our forecast of moderate growth in the current year. For 1988, the Gramm-Rudman-Hollings target calls for a sharp reduction in the federal deficit that, by many analyses, will exert a drag on the economy. This drag may not be fully reflected in the private forecast referred to above because private forecasters may assume that the Gramm-Rudman-Hollings target will not be met. Our baseline economic projection of 3 percent real growth for calendar 1988 assumes that the Gramm-Rudman-Hollings target will be met, in part, by asset sales. We expect that the 1988 reduction of the federal deficit will be in large part offset by improvement in foreign trade, which is already beginning to show in the data.

1. Blue Chip Economic Indicators, February 10, 1987, p. 8

Because CBO's economic projection is quite strong for the next two years, it does not appear necessary to take fiscal actions to ward off recession. The timing and effects of such fiscal stabilization efforts have in any case proved problematic in the past.

Question

Since October, you have revised spending upward by $17 billion for FY 1987. Assuming no legislative changes, what is the probability that your August update of the budget will be considerably more pessimistic than your January estimates?

Answer

CBO's budget figures represent our best estimates of what spending, revenues, and the deficit would be under the assumed fiscal policies. The actual results will doubtless diverge from the estimates, but the likelihood of overestimating the deficit should be roughly equal to the likelihood of underestimating it. While it is not possible to assign precise probabilities to alternative outcomes, we cannot rule out the recurrence of unforeseen developments of the sort experienced in late 1986.

Question

In terms of the impact upon the economy, is there any difference between a $15 billion tax increase (e.g., gasoline tax) versus a $15 billion decrease in outlays or $15 billion of loan asset sales? Please explain the difference.

Answer

Changes in different types of federal taxes and spending may have different multiplier effects on the economy in the short run and different effects on economic efficiency in the long run. Various combinations of spending and tax changes that reduce the deficit by $15 billion could produce similar macroeconomic outcomes. But there is widespread agreement that views about the appropriate size of government and the appropriate distribution of income are more important to the choice of a fiscal policy mix than are the likely differences in the macroeconomic impacts of alternative fiscal policy programs.

Asset sales, however, are truly different in nature. Such sales are not thought to have significant effects on the demand for goods and services. The reason is that asset sales are simply a substitute for government borrowing that alters the ownership of existing assets without affecting incomes. Thus, although asset sales reduce the budget deficit under current accounting procedures, they do not have the macroeconomic effects attributable to other deficit-reducing measures.

**Question**

By OMB's own admission, they have missed the deficit target for FY 1989 and beyond by $20 billion. Last year the President submitted a budget which met the target each year. In your opinion, does the Balanced Budget Act (Gramm-Rudman-Hollings) require the President's budget to meed the deficit target for each year?

**Answer**

The Balanced Budget Act requires that "the deficit set forth in the budget so transmitted [by the President] for any fiscal year shall not exceed the maximum deficit amount for such fiscal year as determined under paragraph (7) of Section 3 of the Congressional Budget and Impoundment Control Act of 1974...."

It is clear that the quoted language requires the President's recommendations for the budget year--meaning fiscal year 1988 at this time--to adhere to the Gramm-Rudman-Hollings target for that year. Whether the language also calls upon the President to present a budget plan for the out-years that is consistent with the Gramm-Rudman-Hollings target for those years is a legal issue on which this office cannot provide an authoritative answer.

In any event, according to CBO's analysis, the President's budget recommendations for fiscal year 1988 would, if enacted without change, result in a deficit exceeding the Gramm-Rudman-Hollings maximum target deficit of $108 billion that year. The Gramm-Rudman-Hollings target deficits in all later years for which the statute specifies a target are exceeded both in the President's budget and in CBO's reestimates. However, the operation of Gramm-Rudman-Hollings depends highly on forecasting, specifically on CBO's forecast. The law does not make the President's budget illegal so long as he meets the target by his own forecast.

Chairman ROSTENKOWSKI. Are there any further questions? If not, Dr. Penner, thank you very much.

Mr. PENNER. You are welcome, sir.

Chairman ROSTENKOWSKI. You have been most helpful and informative. I again want to express not only the gratitude of the chairman of the committee but the gratitude of the entire committee in the assistance that you have given us. I wish you well.

[Whereupon, at 12:40 p.m. the hearing was adjourned, to reconvene at 9:30 a.m., Wednesday, February 11, 1987]

# OVERVIEW OF THE PRESIDENT'S BUDGET FOR FISCAL YEAR 1988

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WEDNESDAY, FEBRUARY 11, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, DC.*

The committee met, pursuant to call, at 9:30 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. Today, we continue the committee's hearings on the President's budget, and the impact of the deficit on the economy. We will hear from a panel of distinguished economists. Their views on the state of the economy, the real size of the deficit, and the impact of various deficit reduction plans will be of great interest to the committee.

The committee will be facing some very tough decisions in the next few months. Today's testimony will help us in assuring that those decisions are based on sound fiscal policy.

I might say, before I yield to my colleague, that I certainly welcome you, John. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I would also like to welcome you, gentlemen. I think all four of you have testified before this committee more than once, and your contributions have always been very helpful in the problems that we have been trying to solve.

We have asked you here today to discuss economic policy and the President's fiscal year 1988 budget. Both the administration and the Congressional Budget Office have forecast moderate real growth in the economy in 1987 and 1988. Although CBO is less optimistic than the administration in that regard, there are many uncertainties in all of these forecasts.

Chief among them are the Federal budget deficit, the U.S. trade deficit, and the policies which Congress and the administration use to address them.

I hope your comments will address your expectations for the short-term as well as the long-term performance of the economy, as well as your assessment of the administration forecast.

Welcome.

Chairman ROSTENKOWSKI. Well, gentlemen, you know the format here. We would like to lead off with Dr. Greenspan and follow through in the order which you are sitting. I need not make the observation, I am sure, that you have made great contributions to the committee in the past.

A great deal of legislation has developed mainly because of the exchanges that we have had gentlemen, with your field of endeavor.

We are all aware of the problems that we face. Our deficit is something we cannot ignore any longer, and it is really ironic that we are working on trade and the budget at the same time, because one compliments the other.

We have to get our house in order in both areas, and so, having you back is like old times. I am sure that the newer members of the committee will enjoy your input as much as I have.

Alan, we know that you are going to have to leave, but it doesn't mean that we wouldn't like you to stay as long as possible to answer some questions. With that, if you would lead off the testimony, we will go down in sequence and then get into a discussion.

Dr. Greenspan, identify yourself for the record so we may proceed.

## STATEMENT OF ALAN GREENSPAN, PH.D., PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Mr. GREENSPAN. I am Alan Greenspan, chairman of Townsend-Greenspan & Co., Inc., economic consultants in New York.

Mr. Chairman, it is always a pleasure to appear before you, and I trust that I will confront some of the issues in my opening remarks, and hopefully address what other questions you have subsequently.

Fragmentary data suggest that the Federal budget deficit totaled $3.5 billion last month, which would bring the cumulative deficit for fiscal year 1987 to $68 billion, a substantial improvement over the $82 billion for the first 4 months of fiscal year 1986.

This is the first real sign that the actual budget deficit has turned. Until now, the improvement in the deficit showed up only in forecasts of official agencies or optimistic private economists.

There is now a growing concern that especially under the proddings of Gramm-Rudman-Hollings, the deficit will shrink too rapidly, creating fiscal drag and possibly pulling the economy down with it. I believe such concerns are misplaced. Rapid deficit reductions that are perceived to be credible long-term adjustments by the financial markets, will also significantly lower real interest rates and propel private capital investment into a major expansion. Such an expansion is likely to add more than sufficient effective demand to offset any drag on the economy coming from deficit reduction.

Any deficit reduction that is politically feasible is unlikely to be excessive. Excess concern for deficit reduction, if taken seriously, is likely to divert the attention of the Congress from the more difficult and still seemingly intractable long-term problems of the Federal budget deficit.

Nonetheless, I believe that the Congress will find it necessary to raise the ceilings currently contemplated for the budget deficit under Gramm-Rudman, not because it is economically desirable to do so, but because the current goals are out of reach politically. With all its flaws, the Gramm-Rudman process is nonetheless desirable. Its discipline should be adhered to even under revised budget deficit projection goals.

The economy, at the moment, seems to be doing reasonably well, though it is likely to fall somewhat short of the administration's GNP growth goals of 3.2 percent over the next four quarters. The shortfalls, however, should be small, and I would not consider that the current projections of the administration as outside the range of reasonable forecasts. However, even given normal GNP projections, I doubt that budget receipts can rise by the contemplated 9.5 percent this year and 9 percent next.

Specifically, I take issue with the administration's projected 29-percent increase in pre-tax profits for calendar year 1987, followed by another 10.5-percent increase next year. This is a particularly important element in their forecast, since it creates a significant surge in corporate tax receipts and, as a consequence, a significant reduction in both the fiscal year 1987 and 1988 deficits. Actual corporate income tax receipts are likely to fall $10 to $15 billion short of projections for this year.

I might add parenthetically that a 29 percent increase in pretax corporate profits, on a national income accounts basis, implies a very much greater increase in per share earnings reported by companies. This results from the expectation that this year's asset writedowns in the shareholder reported returns—which are excluded from national income accounts and Internal Revenue Service liability calculations—will be far less than those of last year. Even the sharp runup in stock prices of recent weeks has not implicitly contemplated such as extraordinary profits growth.

Somewhat less questionable is the short-term projected bulge in corporate profit receipts resulting from the presumed failure of a number of corporations to contemplate the recission of the investment tax credit until late last year. This has required an acceleration of estimated and final payments on calendar 1986 liabilities, which are reflected in a bulge in receipts in fiscal 1987. Since the actual liabilities for calendar 1986 are only very approximately known, how much additional receipts in fiscal 1987 on those liabilities will arrive at the Treasury is of necessity only an approximation. To the extent that there is a bureaucratic bias in the estimating procedures, history tends to suggest that they are likely to be overestimated.

The tax data analysis in both Treasury and the Congress have endeavored, where possible, to anticipate how corporate management was likely to adjust to the new tax law and, accordingly, embody those changes in behavior in their estimates of receipts. Here, too, I suspect that the estimates are likely to be optimistic, however. There are almost surely as yet unearthed loopholes that will cut corporate tax liabilities and payments. These, of course, are not anticipated by the tax analysts for, obviously, were such loopholes, that is unintended tax reductions, unearthed, the Congress would have adjusted the code in advance. The only major one that seems to have surfaced so far, which is being partially closed, is the potential problem in estate taxes.

Individual tax estimates appear to be somewhat more straightforward, although even here there is a lot of potential slippage. Fiscal year 1987 receipts include a one-shot capital gains tax receipt reflecting the large sales of assets before the capital gains tax rate was raised. Although the estimates embodied in fiscal year

1987 tax receipts have not been made public, it appears that the order of magnitude reflects approximately $10 billion in additional receipts. While, again, the tax analysts have made provisions for changes in individual behavior relative to the changing Tax Code, past experience with the IRA's, for example, raises questions about potential underestimation of taxable revenues, as a consequence of the tax bill.

The basic problem with the Federal budget deficit, however, is the current structural imbalance that will eventually have to be redressed, if private capital investment can add to our competitive capabilities. We tend, of necessity, to be excessively focused on short-term programmatic changes in various different defense appropriation items or various different forms of asset sales. Moreover, we delude ourselves into believing that because our long-term budget projections are inevitably benign, that time will ultimately resolve the problem one way or the other. It probably will, if for no other reason than financing difficulties will eventually exert pressure for a quasi-permanent solution. The difficulty is that the long-run solution is almost surely going to mean increasing taxes. Such a solution will once again underwrite the seemingly inexorable upward drift of Federal spending as a share of the national product. The composition of Federal outlays continues to change decade by decade, with defense alternately rising and falling as an overall share, but total outlays seem irresistibly to take an ever-increasing share of national economic output. Federal outlays as a percentage of the GNP totaled only 17 percent during fiscal year 1956, rose to 21.5 percent in 1968 at the peak of the Vietnam war, but, with real defense outlays sharply lower through 1975, the percentage stabilized, at least temporarily. Domestic spending filled the gap of lower defense outlays, however, and continued growth in the latter brought outlays to 22 percent of GNP by 1976. The inevitable rebound of defense brought total outlays to 24.3 percent of GNP in fiscal year 1983. In fiscal year 1986, it had retreated slightly to 23.8 percent.

The administration is forecasting a significant decline in the budget deficit and spending's share of the GNP over the next several years, but the gains are likely to be far short of what is now officially contemplated either by OMB or CBO.

The basic budgetary problem is, at root, political. We remain a democratic society in which Members of the Congress are competitively pressured in most areas of the country to, in effect, buy votes from their constituents by offering what is perceived of as costless benefits. Congress, to be sure, somewhat to my surprise in recent years, has endeavored where possible to pull back from that practice and try to hold the line on new programs. Indeed, very few if any major new spending initiatives have been created in recent years. That, of course, has been the cause of the significant retrenchment in domestic spending as a share of the GNP.

The most encouraging indication that we may, in fact, be able to balance our fiscal accounts is the way in which the political negotiations on the tax bill requiring revenue neutrality were conducted. I don't believe the tax bill was in fact revenue neutral, but it is sufficiently close to suggest that the Congress does at least have the capability under certain restricted institutional conditions of

balancing costs and benefits. The experience of the last few years raises a question of whether the long-term institutional bias toward increasing Federal Government outlay shares of the GNP has come to an end. I must say that I remain skeptical. But I would like to be proved wrong.

Thank you very much, Mr. Chairman.

Chairman ROSTENKOWSKI. Mr. Schultze?

## STATEMENT OF CHARLES L. SCHULTZE, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. SCHULTZE. Thank you, Mr. Chairman.

I appreciate the opportunity to come back and talk with you again. I want to talk about three aspects of budget policy. I am not going to read all of my testimony, and summarize as I go.

Chairman ROSTENKOWSKI. Your entire statement will be included in the record.

Mr. SCHULTZE. First, with no major changes in current policy, what is likely to be the path of Federal budget deficits over the next 3 or 4 years? Second, what will be the main economic consequences of those deficits?

The third question, what are the main steps that have to be taken to improve the outlook for the budget deficits and the economy?

Let me start with the future of Federal budget deficits. Several years ago, CBO projected deficits in excess of $200 billion, more than 5.5 percent of GNP, stretching on into 1990's. The latest CBO projections for fiscal years 1987 and 1988 show deficits falling into a range of $170 to $175 billion, on the assumption of no further changes in budget policy.

The main reason for those lowered deficits is a change in the outlook for the defense budget. Following congressional outcomes in the last few years, the CBO now estimates that there will be no future growth in the real value of defense outlays.

I see no reason to quarrel with these estimates through fiscal year 1988. Thereafter, however, the CBO projects another large drop in the deficit, even without further budget cutting actions. They take the budget deficit down to $134 billion by 1990, and $80 billion by 1992, and this may be excessively optimistic for three reasons:

First, it assumes that short-term interest rates—on Treasury securities—decline to 5.25 percent and long term to under 6 percent over the next 5 years, and that is too sanguine, given the size of the remaining budget deficits.

Second, apart from the recent reductions in defense spending, there has been a tendency to overestimate the consequences of congressional budget cutting actions and to underestimate budget spending. Budget outlays for the more distant years tend to creep above earlier projections.

Finally, in the past 6 years, budget stringency in the civilian programs in the Federal Government have been enforced not so much by eliminating or radically paring particular programs, but by across-the-board penny-pinching. We are accumulating a backlog of

needs that are going to have to be met and will add to the budget deficit, not in a huge way, though.

A prudent estimate based on continued moderate growth in GNP, with no further deficit cutting actions, is that the Federal deficit will fall to the neighborhood of $170-odd billion in 1988. It may then decline only a little further and remain stuck in the neighborhood of $160 to $170 billion, some 3 percent of GNP, by 1990.

If that is right, what are the economic consequences? To evaluate the economic consequences of this pattern of deficits, I have to digress to make some assumptions about the behavior of the Federal Reserve. Ever since 1983, the principal objective of the Fed seems to have been to keep the growth of the GNP within a set of upper and lower limits. In this kind of world, it is the monetary policy of the Federal Reserve, not fiscal policy as reflected in budget deficits, that in short run determines the overall path of GNP, of employment and of inflation.

For that reason, the budget deficits have had their primary effect so far not on the level of U.S. economic activity, but on its structure and its composition. And those effects have been and will continue to be harmful, especially for the Nation's long-term growth prospects.

For the past four years, the Federal Government, in order to finance its deficit, has been borrowing an amount equal each year to some 5 percent of GNP. And this has occurred in a country whose net saving rate, outside the Federal Government, normally ranges from 8 to 9 percent of GNP.

From 1960 to 1979, Federal borrowing outside of recession periods had averaged about 1 percent of GNP. Where did the additional 4 percent of GNP that the Federal Government has recently been borrowing come from? Looking at the source of those funds will tell us how the deficit has affected the structure of our economy.

There are four and only four sources from what that additional borrowing could come. One possibility would be the creation of new money and credit by the Federal Reserve. But as I indicated earlier, the Fed, to meet its prime objective of preventing a renewal of inflation, has not been willing to finance the budget deficit with injections of new money.

That leaves three other possible remaining sources. The first of these, and the most desirable, is that the additional four of GNP going to Federal borrowing would come from additional private saving. But that did not happen. Indeed, the private U.S. saving rate, net of economic depreciation, is now a little below the low end of its historical 8- to 9-percent range.

The second possibility would be that saving was diverted from the financing of housing construction and business investment to meet the increased Federal borrowing. In recent years, net private investment in the United States has indeed fallen compared to its historical average. But the decline was not large. Only about 1 percentage point, or perhaps a quarter of the extra Federal borrowing has so far been financed at the expense of private investment.

That leaves the third and final source: Borrowing from abroad to supplement our own limited domestic saving. And to date, that is

how we did finance three-quarters of the additional budget deficit. Foreign funds flowed into the pool of available saving here in the United States, so that we could finance our swollen budget deficits and still continue with most of our normal domestic investment.

Given a limited flow of new credit from the Federal Reserve, the Federal borrowing, when combined with private borrowing, produced very high interest rates in the United States compared to the rest of the world. It made dollar investments very attractive to foreigners, drove up the exchange value of the U.S. dollar, and generated a huge U.S. trade deficit. Dollar for dollar, the mirror image of that deficit in our international payments is an inflow of foreign funds into this country. The only way we can import more than we export is to borrow from abroad. And so, we have in effect financed almost three-quarters of our added budget deficit from an inflow of foreign saving.

The sequence of events which permitted this to happen has been costly to the United States, however.

The cost has been the structural distortions and hardships that go with a trade deficit of this size, and even more importantly, the piling up of foreign debts the payment of debt service on which will depress American living standards in the future.

Moreover, this source of deficit financing cannot last. Each year now, we are issuing to the world some $140 billion of additional dollar-denominated liabilities. The United States cannot keep running balance-of-payment deficits of a magnitude such as continuously to raise the ratio of foreign debt to our GNP. Ultimately, the dollar has to decline enough to prevent this, and the fear that such a dollar decline will occur makes the dollar an increasingly risky investment for the likes of German pension funds and Japanese life insurance companies.

At any given level of U.S. interest rates, the dollar becomes less and less attractive, and of course, the exchange value of the dollar falls.

As you know, this process of dollar decline began some time ago. And the drop in the private demand for dollars on the part of foreigners has been even larger than appears on the surface. During the second and third quarters of 1986, the last period for which there are complete data, foreign central banks and other official institutions took a huge, 40 percent of the dollar obligations that were issued to cover our balance of payment deficit.

The decline in the dollar to date will turn the U.S. trade deficit down. Measured in volume terms, that trade deficit will shrink substantially over the four quarters of 1987. Because import prices are rising, the dollar value of the trade deficit will shrink later and slower, but it too will decline sharply.

Indeed, I believe the U.S. trade deficit will eventually fall close to zero; not quickly of course, but by the early 1990s. The decline that has occurred in the dollar so far is not enough to do that. Adjusted for international differences in rates of inflation, the dollar is now probably still 5 to 10 percent above where it was in 1980. It jumps around so much that I had to put a broad range in there to make sure I was right today. Eventually, it may have to fall below the 1980 level.

If several years from now, as the trade deficit becomes a relatively small number, the Federal budget deficit has not also shrunk to a small number, we are not going to like all of the consequences of the lower trade deficit. As that trade deficit shrinks, the inflow of foreign funds that have been supplementing our own saving will dry up. Without further budget cutting action, the United States will then have to finance a budget deficit equal to 3 percent of GNP principally out of its own limited net saving, now running, as I said, at only 8 percent of GNP. Interest rates will then have to rise so as to squeeze out enough housing construction and growth promoting business investment to make room for financing the Federal budget deficit.

We will, by then, have stopped accumulating foreign debt and adding to foreign debt service. But we will be reducing the domestic investment needed to maintain our already low productivity growth. The fundamental long-run problem, therefore, is the size of the remaining budget deficit. So long as it stays high, the disappearance of our trade deficit will simply shift the problem to another part of the economy.

Let me hasten to point out that this is not a problem for 1987. Given the CBO projections, the budget deficit will decline over the four quarters of 1987 by something like $30 billion. Over that same time period, the U.S. trade deficit will also be falling. The declining budget deficit will tend to dampen the rise in demand for the output of U.S. business firms; the falling trade deficit will increase it. Looked at from the standpoint of the flow of national saving and borrowing, the Federal Government's take out of the national savings pool ought to be shrinking over the next year, just as the inflow of foreign savings dries up.

The two movements won't exactly balance, but they don't have to. There will, of course, be many other elements affecting the way the economy behaves, but the offsetting forces flowing from the changes in the budget and trade deficits will be the principal features of 1987.

Barring further changes in budgetary policy, however, the decline in the Federal budget deficit will slow sharply in fiscal year 1988, and for all practical purposes come to an end. But the trade deficit will continue to decline and the consequences I outlined earlier—rising interest rates and declining domestic investment—will begin to be a threat.

No one can confidently forecast the speed at which the trade deficit will fall; other economic changes can also occur. And so, precisely when these consequences will show up is highly uncertain. But show up they will.

As a theoretical proposition, I ought to warn that even though the budget deficit in 1988 and later years must be brought down further, it should not be brought down too rapidly. A budget deficit that dropped all the way to the Gramm-Rudman-Hollings target in 1988 would mean a decline of $60 to $65 billion all in one year, and that is too much. On the other hand, to paraphrase an expression I originally heard from Senator Moynihan, I rank the fear that the budget deficit will be cut too rapidly as 38th on my list of worries, right after my fear of being eaten by piranhas.

A reasonable path of deficit decline that should not give the economy transition problems, might be about $30 to $40 billion a year. This is about the original decline path foreseen under Gramm-Rudman-Hollings, but it must now be applied from today's higher base.

That would mean that Congress would have to make real reductions; that is, not smoke and mirrors, of about $30 billion below the currently projected 1988 budget. The reductions would have to grow to something in the neighborhood of $60 billion a year by 1989 and $85 to $90 billion by 1990, below the $160-odd billion deficit that will otherwise occur.

You need a steady path, but more than would happen if you sat on your hands. The damaging economic consequences, if you sit on your hands, will start in 1988, 1989, and 1990. As the trade deficit declines and the inflow of foreign funds dries up, by maintaining this budget deficit at a high level you will choke off the flow of funds into domestic investment.

Let me conclude by noting after looking at the major areas of the budget, that I see no possibility of getting that deficit on the right decline path without a tax increase. But the likelihood of getting a tax increase before 1990 is extremely low. President Reagan continues to be adamantly opposed. Unfortunately, in this matter, I think he still has a majority of the American people with him. After all, why should they agree to take the bitter medicine of a tax increase when a popular President tells them not only that they do not need it, but that it will positively harm the country? We saw last year what happened to the deficit reduction program put forward by Senators Domenici and Chiles and the Senate Budget Committee in the absence of Presidential support. The memory of 1984 will make sure that the candidate of neither party campaigns in favor of a tax increase in the 1988 Presidential election. In 1989, the new President will, of course, find he has to raise taxes. But it may take a while for him to change course and prepare the political groundwork.

And so, a sober and realistic view has to tell us that it may be in calendar year 1990, and budget year 1991, before we get a really large further reduction in the budget deficit. Because of the consequences I outlined earlier, this delay will not be good for the American economy, particularly its prospects for long-term growth.

I wish this were not so. I have had my share of wrong forecasts in the past. I hope I am wrong this time; but I don't think so.

Thank you, Mr. Chairman.

[The statement of Mr. Schultze follows:]

Statement

of

Charles L. Schultze*
Brookings Institution

before the

Committee on Ways and Means

U. S. House of Representatives

February 11, 1987

Mr. Chairman and Members of the Committee:

I want to give my views about three important questions of federal budgetary policy;

1. With no major changes in current policy what will be the path of federal budget deficits over the next three to four year?

2. What are likely to be the main economic consequences if that path of budget deficits is followed?

3. What are the principal steps that would have to be taken to improve the outlook for the budget deficits and the economy?

The Future of Federal Budget Deficits

Several years ago, the Congressional Budget Office was projecting deficits in excess of $200 billion dollars -- some 5 to 5½ percent of GNP -- stretching on to 1990. The latest CBO projection for fiscal years 1987 and 1988, however, shows deficits falling into a range of $170 to $175 billion, on the assumption of no further changes in budget policy. The central reason for the lower deficits is a change in the outlook for the defense budget. The earlier projections assumed a continuing 5 percent a year growth in the real, inflation-adjusted, level of defense outlays. But Congress in the last several years has made it abundantly clear it was not going to continue funding further real increases in defense spending. The latest CBO estimates properly incorporate that new guideline. They allow for no future growth in the real value of defense outlays. That, together with a fall in interest rates over the last several years, explains most of the drop in the projected deficits from 5½ percent to something like 3½ percent of GNP.

I see no reason to quarrel with these estimates through fiscal 1988. Thereafter, however, the CBO projects another large drop in the deficit, even without further budget-cutting measures. The deficit under current policies is estimated to fall from $170 billion in 1988 to $134 billion by 1990 and $80 billion by 1992. I think this may excessively optimistic for three reasons:

First, it assumes that short-term interest rates (on Treasury securities) decline to 5¼ percent, and long-term rates to under 6 percent over the next five years. I believe that is too sanguine, given the size of the remaining budget deficits -- and as I shall explain -- the likely absence by then of

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*The author is a Senior Fellow at the Brookings Institution. The views set forth here are solely those of the author and do not necessarily represent the opinions of the trustees, officers, or other staff members of the Brookings Institution.

large inflows of foreign funds to help finance the deficit. Each 1 percent increase in interest rates over the CBO forecast would add $20 billion a year to the projected budget deficits of the early 1990s.

Second, apart from the recent reductions in defense spending, there has been a tendency to overestimate the consequences of Congressional budget-cutting actions and to underestimate budget spending. Only last August, for example, the CBO projected the fiscal 1988 budget deficit at $150 billion with no further budget-cutting action and at only $118 billion on the basis of policies incorporated in the 1987 Congressional Budget Resolution. Now, however, because expenditures are overrunning in a number of areas, and because many of the policies incorporated in the Budget Resolution were never put into effect, the 1988 deficit is projected not at $118 billion, and not at $150 billion, but at about $170 billion. Budget outlays for the more distant years tend to creep above earlier projections.

Third, for the past six years budget stringency in the civilian programs of the federal government has been enforced not so much by eliminating or radically paring particular programs, but by across-the-board penny-pinching. The wasteful and the efficient, the low-priority and highly useful, all have felt the same pinch. Across a range of routine but still important government activities a backlog of underfunding has accumulated. The FAA, civilian R&D, and the maintenance of national parks, are a few examples. Inevitably, those needs are going to have to be met. The amounts involved are not huge, but they will add to the deficit problem.

I think a prudent estimate, based on continued moderate growth in GNP, is that with no further deficit-cutting actions by the Congress the federal deficit will indeed fall to the neighborhood of $170 billion in 1988, as estimated by the CBO, but may then decline only a little further and remain stuck in the neighborhood of $160-$170 billion -- some 3 percent of GNP by 1990.

The Economic Consequences of Continued Large Budget Deficits

In order to evaluate the economic consequences of this pattern of deficits we have to make some assumptions about the behavior of the Federal Reserve. Ever since 1983 the Fed has essentially pursued a two-fold policy: Its first objective has been to insure that the huge federal budget deficit did not produce an overheated expansion, leading to a renewal of inflationary pressure. And so, starting in May of 1983, at an unprecedently early stage in the economic recovery, the Fed encouraged, promoted, and permitted a substantial rise in interest rates, despite declining inflation, in order to eliminate the potential overheating that it feared from the budget deficit. But the Federal Reserve also has no intention of putting the economy through the wringer of another recession to get the underlying rate of inflation lower than the 4 percent or so at which it is now running. And so, in the last several years, whenever the economic expansion seemed to be faltering the Fed, a bit cautiously, but nevertheless actively promoted and permitted lower interest rates to keep the expansion going. In sum, the objective of the Fed has been to keep the growth of GNP within a set of upper and lower limits. It has had, not perfect, but reasonable success at this. I think it will continue along these lines.

In this kind of world, it is the monetary policy of the Federal Reserve, not fiscal policy as reflected in budget deficits, that in the short run determines the overall path of GNP, of employment, and of inflation. The budget deficits have had their primary effect so far not on the level of U.S. economic activity, but on its structure and its composition. And those effects have been and will continue to be harmful, especially for the nation's long-term growth prospects.

For the past four years the federal government, in order to finance its deficit, has been borrowing an amount equal each year to some 5 percent of GNP. And this has occurred in a country whose net saving rate, outside the federal government, normally ranges from 8 to 9 percent of GNP. From 1960 through 1979, federal borrowing outside of recession periods had averaged about 1 percent of GNP. Where did the additional 4 percent of GNP that the federal government has recently been borrowing come from? Looking at the source of those funds will tell us how the deficit has affected the structure of our economy.

There are four and only four sources from which that additional borrowing could come. One possibility would be the creation of new money and credit by the Federal Reserve. But as I indicated earlier the Fed, to meet its prime objective of preventing a renewal of inflation, has not been willing to finance the budget deficit with injections of new money.

That leaves three other possible remaining sources. The first of these -- and the most desirable -- is that the additional 4 of GNP going to federal borrowing would come from additional private saving. But that did not happen. Indeed, the private U.S. saving rate, net of economic depreciation, is now a little below the low end of its historical 8 to 9 percent range. The second possibility would be that saving was diverted from the financing of housing construction and business investment to meet the increased federal borrowing. In recent years net private investment in the United States has indeed fallen compared to its historical average. But the decline was not large. Only about 1 percentage point, or perhaps a quarter of the extra federal borrowing has so far been financed at the expense of private investment.

That leaves the third and final source -- borrowing from abroad to supplement our own limited domestic saving. And to date that is how we did finance three-quarters of the additional budget deficit. Foreign funds flowed into the pool of available saving here in the United States so that we could finance our swollen budget deficits and still continue with most of our normal domestic investment. Given a limited flow of new credit from the Federal Reserve, the federal borrowing, when combined with private borrowing, produced very high interest rates in the United States compared to the rest of the world. It made dollar investments very attractive to foreigners, drove up the exchange value of the U.S. dollar, and gradually generated a huge U.S. trade deficit. Dollar for dollar, the mirror image of that deficit in our international payments is an inflow of foreign funds into this country. The only way we can import more than we export is to borrow from abroad.

And so, we have in effect financed almost three-quarters of our added budget deficit from an inflow of foreign saving. The sequence of events which permitted this to happen has been costly to the United States, however. The cost has been the structural distortions and hardships that go with a trade deficit of this size, and even more importantly, the piling up of foreign debts the payment of debt service on which will depress American living standards in the future.

This source of deficit financing cannot last, and indeed has probably begun to shrink already. Foreign investors will not continue indefinitely to finance a U.S. trade deficit of anything like this size. Each year now we are issuing to the world some $140 billion of additional dollar-denominated liabilities. The United States cannot keep running balance of payment deficits of a magnitude such as continuously to raise the ratio of foreign debt to our GNP. Ultimately, the dollar has to decline enough to prevent this, and the fear that such a dollar decline will occur makes the dollar an increasingly risky investment for the likes of German pension funds and Japanese life insurance companies. At any given level of U.S. interest rates the dollar becomes less and less attractive, and of course, the exchange value of the dollar falls. As you know, this process of dollar decline began some time ago. And the drop in the private demand for dollars on the part of foreigners has been even larger than appears

on the surface. During the second and third quarters of 1986 --- the last period for which there are complete data -- foreign central banks and other official institutions took a huge 40 percent of the dollar obligations that were issued to cover our balance of payment deficit.

The decline in the dollar to date will turn the trade deficit down. Measured in volume terms that trade deficit will shrink substantially over the four quarters of 1987. Because import prices are rising, the dollar value of the trade deficit will shrink later and slower, but it too will decline sharply. Indeed, I believe the U.S. trade deficit will eventually fall close to zero -- not quickly of course, but by the early 1990s. The decline that has occurred in the dollar so far is not enough to do that. Adjusted for international differences in rates of inflation, the dollar is probably still 5 to 10 percent above where it was in 1980. Eventually it may have to fall below the 1980 level.

If several years from now, as the trade deficit becomes a relatively small number, the federal budget deficit has not also shrunk to a small number, we are not going to like all of the consequences of the lower trade deficit. As that trade deficit shrinks the inflow of foreign funds that have been supplementing our own saving will dry up. Without further budget cutting action, the United States will then have to finance a budget deficit equal to 3 percent of GNP principally out of its own net saving, now running, as I said, at only 8 percent of GNP. Interest rates will have to rise so as to squeeze out enough housing construction and business investment to make room for financing the federal budget deficit. We will by then have stopped accumulating foreign debt and adding to foreign debt service. But we will be reducing the domestic investment needed to maintain our already low productivity growth. The fundamental long-run problem, therefore, is the size of the remaining budget deficit. So long as it stays high, the disappearance of our trade deficit will simply shift the problem to another part of the economy.

Let me hasten to point out that this is not a problem for 1987. Given the CBO projections, the budget deficit will decline over the four quarters of 1987 by something like $30 billion dollars. Over that same time period, the U.S. trade deficit will also be falling. The declining budget deficit will tend to dampen the rise in demand for U.S. output; the falling trade deficit will increase it. Looked at from the standpoint of the flow of national saving and borrowing, the federal government's take out of the national savings pool ought to be shrinking over the next year, just as the inflow of foreign savings dries up. The two movements won't exactly balance, but they don't have to. There will, of course, be many other elements affecting the way the economy behaves, but the offsetting forces flowing from the changes in the budget and trade deficits will be the principal features of 1987.

Barring further changes in budgetary policy, however, the decline in the federal budget deficit will slow sharply in fiscal 1988, and for all practical purposes come to an end. But the trade deficit will continue to decline and the consequences I outlined earlier -- rising interest rates and declining domestic investment -- will begin to be a threat. No one can confidently forecast the speed at which the trade deficit will fall; other economic changes can also occur. And so precisely when these consequences will show up is highly uncertain. But show up they will.

As a theoretical proposition I ought to warn that even though the budget deficit in 1988 and later years must be brought down further, it should not be brought down too rapidly. Relaxed monetary policy by the Federal Reserve can act as a balance wheel to keep total demand, employment, and output moving forward as the budget deficit declines. But the Fed's capabilities are not unlimited. A budget deficit that dropped all the way to the Gramm-Rudman-Hollings target in 1988 would mean a decline of $60 to $65 billion all in one year, and that is too much. Under current economic circumstances, maintaining reasonable economic expansion in the face of such a large one-year cut in the

deficit would probably require the Fed to engineer interest rate reductions so great as to set off an excessively sharp decline in the dollar. On the other hand, to paraphrase an expression I originally heard from from Senator Moynihan, I rank the fear that the budget deficit will be cut too rapidly 38th on my list of worries, right after the fear of being eaten alive by piranhas.

A reasonable path of deficit decline that should not give the economy transition problems, might be about $30 to $40 billion a year. That is about the original decline path foreseen under Gramm-Rudman-Hollings, but it must now be applied from today's higher base. That would mean that Congress would have to make real reductions -- that is, not smoke and mirrors -- of about $30 billion below the currently projected 1988 budget. The reductions would have to grow to something in the neighborhood of $60 billion a year by 1989 and $85 to $90 billion by 1990, below the $160 odd billion deficit that will otherwise occur.

The Need for Higher Taxes

I see no prospects for achieving deficit reductions of this magnitude without a tax increase. That does not mean taxes have to do the whole job. But they are the critical, and missing, element in a solution.

To drive this point home it is useful to consider very quickly the practical possibilities of budget reduction in the five major areas into which the budget can conveniently be divided: (1) Defense spending; (2) Social security (including Medicare); (3) Interest payments; (4) "All other" civilian spending; and (5) Revenues.

As I said earlier in this testimony the Congress has already stopped the growth in defense spending. While some further reductions might be made without sacrificing the nation's security, I doubt if either politically or substantively those reductions could be very large given the current world political scene.

Neither the Congress nor the Administration has shown the slightest inclination to cut social security benefits. While I think some modest reductions might be politically feasible in the context of a deficit reduction package under which taxpayers also made a contribution, I think it extremely unlikely that even small cuts will be forthcoming under any other circumstances. Some savings might be made in Medicare principally through various limitations on payments to physicians, but again I think it would be dangerous to look for very large savings here.

The Congress can do nothing about interest payments on the debt. You do get a "bonus" when you cut the deficit elsewhere, because it reduces the growth in the national debt. But there is nothing you can do directly.

That leaves the "all other" category. It includes everything else the federal government does, from the FBI, the IRS and the Park Service to federal welfare payments and subsidies to farmers. Total outlays for all these programs are now only $335 billion a year. And here President Reagan and the Congress have already wrought a revolution of sorts. In 1966 and 1967, just before President Johnson's Great Society program really got rolling, spending in this "all other" category amounted to 6½ percent of GNP. By 1977 it had mounted rapidly to 9 percent of GNP and topped out at 9½ percent in 1980. The cuts, savings, and freezes that have been put in place since then will -- even with no further action -- reduce the 1988 share of these programs in GNP back to 6.6 percent, just where it was before Lyndon Johnson, Richard Nixon, and the Congresses of that era really got going. Now there is only a limited amount available to be squeezed out.

From my own set of values there are still places to cut. Some of the cuts proposed by President Reagan make sense. On the other hand, many of them -- and a number of others that I do not find so attractive

-- have been proposed time after time and have been ignored by bipartisan majorities in the Congress. Moreover, there are some areas of government which are important for the smooth running of a modern society and an efficient economy that have been neglected during the past five or six years in the fight to hold down the deficit. Some additional funding will ultimately have to be provided here. On balance, there is some further "wiggle room" for cuts in this "all other" category. But substantive considerations argue that the total available is nowhere near sufficient to do the job that has to be done, and political realities limit the possibilities even further.

The next major step in deficit reduction is going to have to be a tax increase. With agreement on a tax increase, I think it would be possible to put together a comprehensive package that included some additional cuts in civilian spending and possibly even a small contribution from the social security program. A tax increase that would gradually build up to something like $50 billion a year by 1990 is likely to be needed as part of the overall plan.

I think the likelihood of getting a tax increase before 1990 is extremely low. President Reagan continues to be adamantly opposed, and there has been absolutely no sign that he will change his mind during the rest of his term. Unfortunately, in this matter I think he still has a majority of the American people with him. After all, why should they agree to take the bitter medicine of a tax increase when a popular President tells them not only that they do not need it but that it will positively harm the country? We saw last year what happened to the deficit reduction program put forward by Senators Domenici and Chiles and the Senate Budget Committee in the absence of Presidential support. The memory of 1984 will make sure that the candidate of neither party campaigns in favor of a tax increase in the 1988 Presidential election. In 1989 the new President will, of course, find he has to raise taxes. But it may take a while for him to change course and prepare the political groundwork.

And so, a sober and realistic view has to tell us that it may be in calendar year 1990, and budget year 1991, before we get a really large further reduction in the deficit. Because of the consequences I outlined earlier this delay will not be good for the American economy, particularly its prospects for long-term growth. I wish this were not so. I have made my share of wrong forecasts in the past. I hope I'm wrong this time -- but I don't think so.

Chairman ROSTENKOWSKI. Mr. Sinai?

**STATEMENT OF ALLEN SINAI, PH.D., CHIEF ECONOMIST AND MANAGING DIRECTOR, SHEARSON LEHMAN BROS., INC.**

Mr. SINAI. I am Allen Sinai, chief economist at Shearson Lehman Bros. in New York.

I take a rather pessimistic view of the budget situation, both the deficits and the process, and the longer-run fundamental problems that they present.

The Federal budget deficits remain too high, especially as the U.S. economy begins to head for faster growth. Estimated under current conditions and reasonable expectations for the U.S. economy, congressional deliberations, and administration reactions, unified budget deficits are likely to be $189.5 billion in fiscal year 1987; $176 billion in fiscal year 1988, $164.5 billion in fiscal year 1989, and $141.1 billion for fiscal year 1990, far above Government estimates and the targets set by the Gramm-Rudman-Hollings legislation.

On a structural or cyclically adjusted basis, the deficits should be $167 billion in fiscal year 1987, $156 billion in fiscal year 1988, reaching $110 billion in fiscal year 1990. These projections already reflect expectations of reductions in Federal Government spending of $34 billion, $40 billion and $54 billion in fiscal years 1988 to 1990, relative to the current services baseline, not yet approved and effected by the Congress.

Although the Federal budget deficits do seem to be headed lower, regardless of how measured or by whom, no longer to soar so long as the economy keeps expanding, they are too high because severe imbalances are created from the effects of the deficits on interest rates, the dollar, the trade deficit, the economies of the United States and the rest of the world, and patterns of performance across industries and geographic regions.

For the first time in postwar U.S. economic history, large and excessive budget deficits have principally acted to crowd out foreign trade and the industrial sector, crowding in consumption spending instead and creating imbalances and risks for the financial markets. We have to correct them if we are going to have healthy, long-run sustained economic growth, both here and abroad.

Indeed, as the U.S. economy begins to recover from the pronounced weakness of the past 2 years, it is necessary that the Federal budget deficits be reduced by more than currently is in prospect to provide room for the private sector to keep growing.

Structural budget deficits, estimated by Shearson Lehman economics to range from $167 billion to $109 billion over the next few years, even though declining, are too high for growth without the accelerating inflation, overextension, and higher interest rates that typically set the stage for a business cycle downturn.

Though little danger exists now for a recession this year and probably most of next, what happens on the budget during 1987 and 1988 will probably determine whether a downturn occurs as soon as later next year or in 1989.

Today's principal manifestation of the chronic and excessive budget deficits lies in the soaring trade deficits of the past few

years. Expectations of large and growing Federal budget deficits in the face of monetary growth targeting and tight stabilization policies abroad have, one, kept interest rates considerably higher than otherwise would have occurred; two, helped to create an overvalued dollar; three, led to increased consumption of foreign goods by American households and businesses; four, aided foreign penetration of U.S. markets; five, increased the U.S. trade deficit and dependence on financing from abroad; six, reduced U.S. economic growth; and seven put the dollar on a downward course.

A tighter fiscal and easier monetary policy in 1985–86 accelerated the downward turn in the dollar. However, due to lagged reactions in trade and structural impediments, the trade deficits have failed to turn much as yet, putting further downward pressure on the dollar and possibly setting up new imbalances and volatility in economic performance.

The risks to the U.S. financial markets and the economy of the budget deficits is clearly present now, where a taste of dollar-related jitters and fears of too strong growth and higher inflation from the deficits and depressed dollar are being reflected in a modest upward spike of interest rates.

The large U.S. trade deficits, which stem in part from linkages to the budget deficits, depress the dollar. A lower dollar causes expectations of inflation and of more growth later on. To finance the budget and trade deficits, interest rates must rise to attract sufficient funds, both domestic and foreign.

But prospects of higher inflation from the stimulus of excessive budget deficits and an expected improvement in trade prevent expected inflation-adjusted interest rates from rising sufficiently to attract investors.

The dollar remains under pressure and interest rates keep rising. In such a situation, the Federal Reserve is trapped, unable to stop the rising trend for interest rates on its own.

If interest rates rise sufficiently, by one or two percentage points, growth would be threatened and perhaps aborted. Too high inflation, high nomimal interest rates, and stagnation is a possible rather dismal result.

The rises of interest rates so far range from 25 to 50 basis points in just a week or two. Without policy actions to reduce the budget deficits or stop the decline of the dollar, interest rates could move much higher.

Although initially relatively immune to the upticks of interest rates, the stock market eventually would suffer jitters, too, probably in a massive 1- or 2-day selloff. Eventually, the United States' economy would lose the new momentum it has only recently started to gain.

The imbalances now present can no longer be easily corrected by balancing the Federal budget over a relatively short period of time. It is now too late to achieve balance simply by meeting the Gramm-Rudman-Hollings targets. We are beyond the time when the original Gramm-Rudman-Hollings would work.

The amounts required now, given current prospects for unified budget deficits to meet the Gramm-Rudman-Hollings targets, would be extraordinarily large. Calculated from current services budget estimates, in excess of $100 billion per year would be necessary for

the next few years. Assuming the kind of spending cuts the Congress will likely pass with the fiscal year 1988 budget, cuts of $60-some-odd billion would be needed this year, and higher in subsequent years to reach the Gramm-Rudman-Hollings targets.

It is a betwixt and between situation, because if nothing or too little is done, it is also a very bad, negative situation.

Let me summarize a few observations on the administration budget, and the possible impacts if Congress did indeed go ahead and try to meet the Gramm-Rudman-Hollings targets under current prospects.

We find much higher deficits, because basically we expect less economic growth over the next 4 years, on average, than the administration. We would expect unemployment rates to average higher than the administration, and expect interest rates to be significantly higher than the administration, and also the CBO estimates. We also don't think there will be as many reductions in spending as the administration expects. These are the major reasons why our estimates of unified budget deficits are so much higher than the administration, higher than the CBO, and way above the Gramm-Rudman-Hollings targets.

The current administration budget is unrealistic and the prospects for the deficits and deficit reductions—economic assumptions are too optimistic, spending for defense will be larger, the same for agriculture.

The key to sustained growth lies in getting Federal budget deficits down significantly—necessary to compensate the holders of an increasing volume of investable funds abroad.

The committee asked the question whether it would be wise to move to the Gramm-Rudman-Hollings targets. There is an inherent fatal flaw in that legislation which the proponents of the legislation understood at the beginning, because they had some escape clauses in it. It is that if you make the calculations for the reductions in the budget from the unified budget basis, and the economy is weak and unemployment is high, the unified budget deficits are going to be higher than otherwise, and the calculated reductions necessary to meet the GRH targets will be greater than otherwise. Making those reductions will weaken the economy, unless the Federal Reserve can step in with sufficient compensating ease in monetary policy to offset the slack.

The Federal Reserve, although somewhat magical in its operations in the last 5 years, is not enough of a magician to time and compensate in the way of easy monetary policy for the kind of excessive reductions that Gramm-Rudman-Hollings requires, given the way it is calculated.

This fail-safe mechanism in GRH is shutting off the reductions, if we have 1-percent-negative growth. By the time everyone would know that, enough momentum will be set off in the economy, and it will be too late.

The GRH targets are going to have to be readjusted or rethought, or probably what might be better, it would be better to make the calculations in terms of differences between the targets and the cyclically adjusted or structurally adjusted deficits, which take out the effect of the economy on the budget. In doing so, the

required reductions would not be so great, and the potential damage to the economy of overcutting would not be so great.

We have run some simulations which lead me to conclude that we have crossed the point of no return on this budget problem. It is really now counterproductive to meet the Gramm-Rudman-Hollings targets.

In the statement is a table reporting the results of computer simulation with our econometric model, showing what would happen to the economy, interest rates, unemployment, inflation, for reductions in spending only to meet the Gramm-Rudman-Hollings targets. That is in table 4. I won't go through the details, except what is produced is for the next 4 years.

These are differences relative to our current baseline forecast. Our current forecast already assumes some additional cuts not yet passed in the budget, but adding on to the cuts, $45.5, $68, $92.5, and $105.4 billion, and following that through in our calculations produces significantly lower real GNP growth, especially in the early years, a 1.7-percent-average-growth rate for the economy for the next 4 years and we do not buy that much benefit on inflation.

The unemployment rate averages over 7 percent, and we don't get, unless there would be sharp reductions in interest rates, all of that deficit reduction back in terms of an ex post reduction in the budget deficit. The interest rate sectors do well, but most of the economy does not do well.

Suppose the Federal Reserve were smart enough to exactly offset the restrictions involved in getting to the Gramm-Rudman-Hollings targets. This is shown in table 5, and we find that this is an impossible experiment, because you cannot design monetary policy to offset fiscal restraint on a month-by-month, quarter-by-quarter basis; it is impossible.

We found out that we would get tremendous volatility in interest rates, 3 or 4 percentage points. We now are beyond the point where you can solve the problem just by trying to get to the Gramm-Rudman-Hollings targets, that won't work anymore. It is too late.

The best way out now, and this is probably idealistic and unrealistic, requires a grand scheme which would involve a judicious choice of a downward glide path in conjunction with a simultaneous well-maintained monetary policy, and also, if manageable, a simultaneous, coordinated stimulation of the rest of the world's economies by our major trading partners.

This is a tall order, but I mention it because the problem of running these excessive budget deficits for so many years and not having dealt with it fully has got us down a road where the room for maneuver is getting very thin.

This is not to say that the progress made so far has not been encouraging. There has been a tremendous return in the past deficits because of budget-cutting efforts, but more needs to be done.

The ideal approach would be, one, to use the cyclically adjusted Federal budget deficit as the base for calculating the necessary deficit reductions; two, to use a combination of tax changes and spending reductions to establish a downward glide path for the deficits that is between what now appears most likely and the GRH targets; three, apply a gradually easier monetary policy in advance of the budget cuts; and, four, obtain agreement from major trading

partners to shift domestic policies more toward stimulus in return for more budget discipline in the United States.

It is inevitable that some sort of tax increase will eventually be forced on the American economy—the financial markets will not live with the twin deficit problem.

It may happen sooner than you think, and not so late as Dr. Schultze's 1988 or 1989 projection, and so, I would encourage you to look hard at the tax side. I share the feeling that it would be inappropriate and unwise to raise personal income taxes, corporate profit tax rates, not only because of the incentive effects of those tax cuts, but also as a political matter. There is a compact with the American people, who accepted the new tax law on the basis of low tax rates.

You can't now turn around and raise them; but there are other areas of increasing taxes, excise taxes, oil import fees where $10 or $20 billion of revenue can be raised. With some cuts out of nondefense, cuts out of defense, and the Federal Reserve joining in, good progress can be made. If the Federal Reserve eases to compensate for the tightened budget, interest rates would go down because the budget was being tightened and because the Federal Reserve was easing, and the interest rate bonus, in terms of the budget deficit, could be quite sizable. I think you will want to keep that in mind in calculating how one can get budget deficits down.

Interest expense now is a huge part of the Federal deficit, the third largest source of outlays, so the Federal Reserve's role in keeping growth up even as the budget is tightened can help the budget both through the revenues that come from the growth the Fed gives back to the economy, and the reductions in outlays that come because of interest rate reductions.

Outside now of a much more coordinated approach to this problem, I would say that we are risking the new upturn in our economy that is happening now, and by 1989 or 1990, I would be very pessimistic about the prospects for our economy in terms of growth, unemployment, and the standard of living of the American people.

[The statement of Mr. Sinai follows:]

Allen Sinai
Chief Economist
Shearson Lehman Brothers, Inc.
New York, New York

# The Budget, Economy, Deficits and Risks

by Allen Sinai*

The federal budget deficits remain too high, especially as the U.S. economy begins to head for faster growth. Estimated under current conditions and reasonable expectations for the U.S. economy, Congressional deliberations, and Administration reactions, unified budget deficits are likely to be $189.5 billion in FY1987, $176 billion in FY1988, $164.5 billion in 1989 and $141.4 billion for 1990, far above government estimates and the targets set by the Gramm-Rudman-Hollings (GRH) legislation. On a structural or cyclically-adjusted basis, the deficits should be $167 billion in FY1987, $156 billion in FY1988, reaching $109 billion in FY1990.[1] These projections already reflect expectations of reductions in federal government spending of $34 billion, $40 billion and $54 billion in fiscal years 1988 to 1990, relative to the current services baseline, not yet approved and effected by the Congress.

Although the federal budget deficits do seem to be headed lower, regardless of how measured or by whom, no longer to soar so long as the economy keeps expanding, they are too high because severe imbalances are created from the impacts of the deficits on interest rates, the dollar, the trade deficit, the economies of the U.S. and the rest-of-the-world, and patterns of performance across industries and geographic regions. For the first time in postwar U.S. economic history, large and excessive budget deficits have principally acted to "crowd-out" foreign trade and the industrial sector, "crowding-in" consumption spending instead and creating imbalances and risks for the financial markets, the U.S. economy, and rest-of-the-world economies that must be resolved in order to achieve noninflationary growth here and abroad.

Indeed, as the U.S. economy begins to recover from the pronounced weakness of the past two years, it is necessary that the federal budget deficits be reduced by more than currently is in prospect to provide room for the private sector to keep growing. Structural budget deficits, estimated by Shearson Lehman Economics to range from $167 billion to $109 billion over the next few years, even though declining, are too high for growth without the accelerating inflation, overextension, and higher interest rates that typically set the stage for a business cycle downturn.

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Though little danger exists now for a recession this year and probably most of next, what happens on the budget during 1987 and 1988 will probably determine whether a downturn occurs as soon as later next year or in 1989.

Today's principal manifestation of the chronic and excessive budget deficits lies in the soaring trade deficits of the past few years. Expectations of large and growing federal budget deficits in the face of monetary growth targeting and tight stabilization policies abroad have kept interest rates considerably higher than otherwise would have occurred, helped to create an overvalued dollar, led to increased consumption of foreign goods by American households and businesses, aided foreign penetration of U.S. markets, increased the U.S. trade deficit and dependence on financing from abroad, reduced U.S. economic growth, and put the dollar on a downward course. A tighter fiscal and easier monetary policy in 1985-86 accelerated the downward turn in the dollar. However, due to lagged reactions in trade and structural impediments, the trade deficits have failed to turn much as yet, putting further downward pressure on the dollar and possibly setting up new imbalances and volatility in economic performance.

The risks to the U.S. financial markets and the economy of the budget deficits is clearly present now, where a taste of dollar-related jitters and fears of too strong growth and higher inflation from the deficits and depressed dollar are being reflected in a modest upward spike of interest rates. The large U.S. trade deficits, which stem in part from linkages to the budget deficits, depress the dollar. A lower dollar causes expectations of inflation and more growth later on. To finance the budget and trade deficits, interest rates rise to attract sufficient funds, both domestic and foreign. But prospects of higher inflation from the stimulus of excessive budget deficits and an expected improvement in trade and the industrial sector prevent expected inflation-adjusted interest rates from rising sufficiently to attract investors. The dollar remains under pressure and interest rates keep rising. In such a situation the Federal Reserve is trapped, unable to stop the rising trend for interest rates on its own.

If interest rates rise sufficiently, by one or two percentage points, growth would be threatened and perhaps aborted. Too high inflation, high nominal interest rates, and stagnation is a possible result.

The rises of interest rates so far range from 25 to 50 basis points in just a week or two. Without policy actions to reduce the budget deficits or stop the decline of the dollar, interest rates could move much higher. Although initially relatively immune to the upticks of interest rates, the stock market would suffer jitters, too, probably in a massive one- or two-day selloff. Eventually, the U.S. economy would lose the new momentum it has only recently started to gain.

The imbalances now present can no longer be easily corrected by balancing the federal budget over a relatively short period of time. It is now too late to achieve balance simply by meeting the GRH targets. The resulting adjustments would only prove disruptive to an already disrupted economy. It is essential to establish an appropriate downward glide path for the budget deficits, not necessarily the GRH target path, joining U.S. monetary policy and the policies of other countries together with changes in domestic fiscal policy that will substantially lower the prospective federal budget deficits.

Otherwise, large U.S. federal budget deficits superimposed on an improving private sector and only a slow turn for trade will continue to be associated with a lower dollar, risk substantial inflationary pressure and upward spikes on interest rates, and eventually helping to bring the economic expansion to an end. This danger represents an outgrowth of the failure to deal with the budget deficits, once and for all, in the years past. Progress toward reducing the deficits in the last few years has been in the right direction, but not adequate to eliminate the risks to sustained, noninflationary growth for the U.S. and world economies.

This statement deals with the outlook for the federal budget and the deficits, the relation of the deficits to the prospects for the economy, evaluates the wisdom of attempting to meet the GRH targets under current conditions, the manner by which the "twin deficits" and "twin debt,"--federal and trade--now threaten the financial markets and U.S. economy, and presents some suggestions for moving toward a better resolution of the deficits problem.

In summary:

- Under realistic assumptions for growth, inflation, unemployment and interest rates, Shearson Lehman estimates show considerably higher federal budget deficits than the Administration, ranging from $189.5 billion in FY1987 to a still large $141.4 billion in FY1990. Less economic growth, on average, over the next four years, higher unemployment rates, higher interest rates, and fewer reductions in spending than are expected by the Administration produce the higher estimates (Tables 2, 3 below).

- The current Administration budget is unrealistic on the prospects for the deficits and deficit reductions. Economic assumptions are too optimistic. Assumed reductions in spending, especially for nondefense, are too large. Spending on entitlements such as Medicare, Medicaid, and retirement benefits may exceed estimates. Tax receipts from the Tax Reform Act of 1986 are overestimated for FY1987 and FY1988. Farm income supports are probably underestimated. Some of the reported savings are one-shot items, such as loan asset sales. And, it is unrealistic to expect serious deficit reductions without some sort of tax increase as part of a combined approach to reduce the budget deficits (Tables 1, 3 below).

- There are several laudatory features of the budget that should be part of a final FY1988 budget. Among them are a greater reliance on user fees and privatization. User fees for services of the federal government make sense, both as a device to raise revenues and on grounds of efficiency. New charges for the mortgage finance program of the FHA and GNMA, while likely to impact negatively on housing, remove from the housing sector a subsidy that distorts efficiency. The same is true for the increased fee for originations of VA home loans. Coast Guard services long have been user specific and in need of an increased fee program. The same is true for recreation user fees. Privatization, or the selling to the private sector of certain government entities, reduces outlays on a permanent basis and can result in more efficient operations. The sale of Conrail, Amtrak and some oil and power marketing enterprises seem to represent a reasonable thrust in this direction.

- The still excessive budget deficits in prospect, measured on a unified or structural basis, continue to prop long-term interest rates above what would otherwise would be, perhaps by as much as two to three percentage points, distort the value of the dollar, create unnecessary imbalances, and risk the future health of the U.S. economy. As the economy shifts gears to a higher pace of growth and lower unemployment rates, it becomes even more imperative to reduce the federal budget deficits, especially the structural or cyclically-adjusted deficits. Balancing these deficits by the end of the decade should be the goal.

- After years of excessive budget deficits, it is too late now to quickly and abruptly move the deficit toward balance by following the Gramm-Rudman-Hollings (GRH) targets, without disrupting the economy. Simulations with the Shearson Lehman Model of the U.S. Economy show that achieving the GRH targets through spending reductions would significantly reduce the path of real GNP, consumption spending and business equipment outlays over the next few years (Table 4). The stock market, dollar and interest rates would tumble; the latter, with lags, benefitting growth for interest rate and dollar sensitive areas such as net exports, autos and housing. But the economy would stagnate, averaging 1.7% real growth per annum through 1990, accompanied by an unemployment rate in excess of 7% through the rest of the decade. Inflation would drop somewhat, but still average a higher 3.6% a year to 1990.

- A point of no return has been crossed where it is now counterproductive to explicitly and actually meet the GRH targets. Even if attempted, the necessary adjustments by the Federal Reserve to compensate for the lost economic activity could not be taken quickly enough nor coordinated well enough to smooth the adjustment process in an economy that is already fragile. The central bank would have to quickly reduce interest rates by at least several percentage points, almost impossible to do with enough lead time to revive an economy already depressed by the large deficit reductions necessary to reach the GRH targets. By attempting to do so, the central

bank would inject a great deal of volatility into a risk-prone economy through large swings of interest rates. With 12% of goods consumed here purchased abroad and 37% of business equipment spending imported from the rest-of-the-world, any slowdown in the U.S. economy could translate to a similar pattern of weakness abroad. The additional dollar weakness likely if the GRH targets were achieved also would risk further depression of the recessed export and industrial sectors in Japan and Germany.

- The best way out now requires a "grand scheme" which would involve a judicious choice of a downward glide path for the budget deficits in conjunction with a simultaneous well-planned relaxation in monetary policy and a coordinated stimulation of the rest-of-the-world economies by our trading partners. If not done, the problem for the U.S. is that excessive structural budget deficits, the stronger industrial sector that is emerging, and a weak dollar could bring about an undesirable reinflation. Weak growth abroad because of restrictive policies, in turn, would limit growth in the U.S., keeping the dollar down. The resulting path, perhaps all too likely, would be renewed inflationary pressure and an end to the U.S. economic expansion in late 1988 or 1989 without the federal budget deficits having been moved sufficiently lower. The next round could then well result in $250 billion or more deficits and a replay of the same set of problems that have been occurring.

The problem with attempting to meet the GRH targets is that the legislation, as currently constituted, involves an inherent flaw. The unified budget deficits from which the deficit reductions necessary to reach the GRH targets are calculated reflect the performance of the economy. A subpar economy is reflected in higher-than-expected unified budget deficits. In turn, the calculated reductions to meet the GRH targets are larger. Those reductions, if carried out, tend to depress the economy. The ex-ante reductions in deficits then do not occur, ex-post, and further large deficit reductions are required. Although the GRH legislation contains a trigger mechanism that shuts off spending cuts once real growth declines, the negative growth would be perceived too late to prevent accelerating weakness. U.S. economy weakness tends to depress the dollar, which offsets the usual lower interest rate effect from weak growth.

The ideal approach would be 1) to use the cyclically-adjusted federal budget deficit as the base for calculating the necessary deficit reductions; 2) to use a combination of tax changes and spending reductions to establish a downward glide path for the deficits that is between what now appears most likely and the GRH targets; 3) apply a gradually easier monetary policy in advance of the budget cuts, and 4) obtain agreement from major trading partners to shift domestic policies more toward stimulus in return for more budget discipline in the U.S.

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The tax increases need not be large or through higher personal income or corporate profits tax rates. This would be unwise and unnecessary, since the reductions in the budget deficits should be aimed at only a gradual elimination of the cyclically-adjusted budget deficits by the end of the decade. A combination of 1) modestly higher taxes--a $5 per barrel oil import fee and increased excise taxes ($10 billion to $15 billion a year); 2) reductions in both defense and nondefense spending ($20 billion to $40 billion a year); and 3) reductions of interest rates of one to three percentage points a year from the tighter budget and an easier monetary policy could pay handsome dividends in permanent deficit reductions at least cost to growth and inflation. The role of more stimulus in the rest-of-the-world would be to pick up some of the economic slack from a tighter budget that is not easily offset by the Federal Reserve.

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Footnotes

[1] The structural or cyclically-adjusted budget estimates show the outlays, revenues and deficits that would result if the economy were at full employment, defined as a 6% unemployment rate and 2.8% growth in potential real GNP. This measure attempts to remove the effects of the economy on budget prospects and provides a better, although still imperfect, approximate measure of budget stimulus or restraint.

**Table 1**
**Administration Budget Projections**
**(Billions of Dollars, Fiscal Years)**

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| Budget Proposals | | | | | | |
| Receipts | 769.1 | 842.4 | 916.6 | 976.2 | 1,048.3 | 1,123.2 |
| Outlays | 989.8 | 1,015.6 | 1,024.3 | 1,069.0 | 1,107.8 | 1,144.4 |
| Nondefense | 716.4 | 733.4 | 726.7 | 756.8 | 777.8 | 794.9 |
| Defense | 273.4 | 282.2 | 297.6 | 312.2 | 330.0 | 349.5 |
| Appropriations | 289.1 | 292.9 | 312.0 | 332.4 | 353.5 | 375.0 |
| Deficit | 220.7 | 173.2 | 107.7 | 92.8 | 59.5 | 21.2 |
| Percent of GNP | 5.3 | 3.9 | 2.3 | 1.8 | 1.1 | 0.4 |
| Structural Budget Deficit | 172.5 | N/A | N/A | N/A | N/A | N/A |
| Percent of GNP | 4.1 | N/A | N/A | N/A | N/A | N/A |
| Current Services Basis* | | | | | | |
| Receipts | — | 842.3 | 910.4 | 968.2 | 1,039.7 | 1,114.3 |
| Outlays | — | 1,016.8 | 1,060.5 | 1,115.1 | 1,165.4 | 1,215.5 |
| Nondefense | — | 734.6 | 763.0 | 802.9 | 835.4 | 866.0 |
| Defense | — | 282.2 | 297.6 | 312.2 | 330.0 | 349.5 |
| Appropriations | — | 292.9 | 312.0 | 332.4 | 353.5 | 375.0 |
| Deficit | — | 174.5 | 150.1 | 146.9 | 125.7 | 101.2 |
| Percent of GNP | — | 3.9 | 3.2 | 2.9 | 2.3 | 1.7 |
| Outlay Adjustment to Deficit for GRH | — | 11.0 | 11.0 | 11.0 | 11.0 | 11.0 |
| Defense | — | 7.0 | 7.0 | 7.0 | 7.0 | 7.0 |
| Nondefense | — | 4.0 | 4.0 | 4.0 | 4.0 | 4.0 |
| Deficit Adjusted for GRH | — | 163.5 | 139.1 | 135.9 | 114.7 | 90.2 |
| Structural Budget Deficit | 192.7 | N/A | N/A | N/A | N/A | N/A |
| Percent of GNP | 4.6 | N/A | N/A | N/A | N/A | N/A |

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| Economic Assumptions (Calendar Years, Except Where Noted) | | | | | | |
| Real GNP (% Chg. 4th Qtr./4th Qtr.) | 2.7 | 3.2 | 3.7 | 3.6 | 3.6 | 3.5 |
| GNP Deflator (% Chg. 4th Qtr./4th Qtr.) | 2.6 | 3.6 | 3.5 | 3.5 | 3.0 | 2.7 |
| Real GNP (% Chg.) | 2.7 | 3.1 | 3.5 | 3.6 | 3.6 | 3.5 |
| GNP Deflator (% Chg.) | 2.8 | 3.3 | 3.5 | 3.5 | 3.2 | 2.8 |
| Unemployment Rate (%) | 6.9 | 6.7 | 6.3 | 6.0 | 5.8 | 5.6 |
| 91-Day Treasury Bill Rate (%) | 6.0 | 5.4 | 5.6 | 5.3 | 4.7 | 4.2 |
| 10-Year Treasury Note (%) | 7.7 | 6.7 | 6.6 | 6.1 | 5.5 | 5.0 |

* *Receipts and outlays under current law, assuming no change in law and continuation of programs at existing levels.*

*Source: Office of Management and Budget, January 28, 1987*

**Table 2**
**Shearson Lehman Budget Projections**
**(Billions of Dollars, Fiscal Years)**

| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|
| Budget Projections | | | | | | |
| Receipts | 734.1 | 769.1 | 828.0 | 883.0 | 952.5 | 1,026.6 |
| Outlays | 946.3 | 989.8 | 1,017.5 | 1,059.0 | 1,117.0 | 1,168.0 |
| Nondefense | 693.6 | 716.4 | 735.5 | 774.0 | 822.0 | 863.0 |
| Defense | 252.7 | 273.4 | 282.0 | 285.0 | 295.0 | 305.0 |
| Appropriations | 294.7 | 286.8 | 292.0 | 304.0 | 315.0 | 325.0 |
| Deficit | 212.3 | 220.7 | 189.5 | 176.0 | 164.5 | 141.4 |
| Percent of GNP | 5.4 | 5.3 | 4.3 | 3.8 | 3.3 | 2.7 |
| Structural Budget Deficit | 164.4 | 197.0 | 167.0 | 156.0 | 145.0 | 109.0 |
| Percent of GNP | 4.2 | 4.7 | 3.8 | 3.3 | 2.9 | 2.1 |
| Treasury Financing | | | | | | |
| Deficit | 212.3 | 220.7 | 189.5 | 176.0 | 164.5 | 141.4 |
| Cash Adjustments and Other Means of Finance | -15.0 | 15.5 | 1.0 | 1.0 | 1.0 | 1.0 |
| Total Treasury Financing | 197.3 | 236.2 | 190.5 | 177.0 | 165.0 | 142.4 |
| Debt Held by the Public (End of Year) | 1,509.9 | 1,746.1 | 1,936.6 | 2,113.6 | 2,279.1 | 2,421.5 |
| Percent of GNP | 38.3 | 41.9 | 44.4 | 45.3 | 45.3 | 45.8 |
| Net Interest Cost | 129.1 | 135.3 | 139.0 | 149.0 | 158.0 | 162.0 |
| Percent of GNP | 3.3 | 3.2 | 3.2 | 3.2 | 3.1 | 3.1 |
| Current Services Basis* | | | | | | |
| Receipts | — | — | — | 883.0 | 952.5 | 1026.6 |
| Outlays | — | — | — | 1,093.0 | 1,157.0 | 1,222.0 |
| Nondefense | — | — | — | 803.0 | 852.0 | 902.0 |
| Defense | — | — | — | 290.0 | 305.0 | 320.0 |
| Appropriations | — | — | — | 310.0 | 325.0 | 340.0 |
| Deficit | — | — | — | 210.0 | 204.5 | 195.4 |
| Percent of GNP | — | — | — | 4.5 | 4.1 | 3.7 |
| Outlay Adjustment to Deficit for GRH | — | — | — | 11.0 | 11.0 | 11.0 |
| Defense | — | — | — | 7.0 | 7.0 | 7.0 |
| Nondefense | — | — | — | 4.0 | 4.0 | 4.0 |
| Deficit Adjusted for GRH | — | — | — | 199.0 | 193.5 | 184.4 |
| Structural Budget Deficit | 162.0 | 192.7 | 167.0 | 190.0 | 185.0 | 163.0 |
| Percent of GNP | 4.2 | 4.6 | 3.8 | 4.1 | 3.7 | 3.1 |

| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|---|
| Economic Assumptions (Calendar Years, Except Where Noted) | | | | | | |
| Real GNP (% Chg. 4th Qtr./4th Qtr.) | 2.9 | 2.2 | 3.0 | 3.3 | 1.9 | 0.5 |
| GNP Deflator (% Chg. 4th Qtr./4th Qtr.) | 3.3 | 2.2 | 3.5 | 4.0 | 4.7 | 4.0 |
| Real GNP (% Chg.) | 2.7 | 2.6 | 2.4 | 3.2 | 1.5 | 0.8 |
| GNP Deflator (% Chg.) | 3.3 | 2.7 | 2.9 | 3.9 | 4.8 | 4.1 |
| Unemployment Rate (%) | 7.2 | 7.0 | 6.7 | 6.4 | 6.7 | 6.8 |
| 91-Day Treasury Bill Rate (%) | 7.5 | 6.0 | 5.4 | 5.8 | 7.5 | 6.8 |
| 10-Year Treasury Note (%) | 10.6 | 7.8 | 7.4 | 7.8 | 9.1 | 8.4 |

* *Receipts and outlays under current law, assuming no change in law and continuation of programs at existing levels.*

**Table 3**
**Comparison of Shearson Lehman and Adminstration Budget Estimates**
**(Billions of Dollars, Fiscal Years)**

| | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|
| Shearson Lehman Current Services Deficit (1) | 189.5 | 210.0 | 204.5 | 195.4 |
| Administration Current Services Deficit | 173.2 | 150.1 | 146.9 | 125.7 |
| Differences | 16.3 | 59.9 | 57.6 | 69.7 |
| Receipts | 14.4 | 27.4 | 15.7 | 13.1 |
| Due to: Economic Assumptions | 11.4 | 12.3 | 13.0 | 28.6 |
| Economic Growth | 8.4 | 10.7 | 16.5 | 37.1 |
| Inflation | 3.0 | 1.6 | -3.5 | -8.5 |
| Technical Differences and Other (2) | 3.0 | 15.1 | 2.7 | -15.5 |
| Outlays | 1.9 | 32.5 | 41.9 | 56.6 |
| Due to: Economic Assumptions | 1.7 | 9.5 | 23.6 | 36.8 |
| Unemployment | 2.0 | 4.0 | 6.0 | 8.0 |
| Inflation (Indexed Social Programs only) | -1.8 | -0.5 | -0.4 | 3.8 |
| Interest Costs | 1.5 | 6.0 | 18.0 | 25.0 |
| Technical Differences and Other | 0.2 | 23.0 | 18.3 | 19.8 |
| Defense (3) | -0.2 | -7.6 | -7.2 | -10.0 |
| Nondefense (4) | 0.4 | 30.6 | 25.5 | 29.8 |
| Shearson Lehman Projected Deficit (Unified) | 189.5 | 176.0 | 164.5 | 141.4 |
| Administration Proposed Deficit(Unified) | 173.2 | 107.7 | 92.8 | 59.5 |
| Differences (due to differences in current services and changes in policy) | 16.3 | 68.3 | 71.7 | 81.9 |
| Receipts | 14.4 | 33.6 | 23.7 | 21.7 |
| Due to: Economic Assumptions (as above) | 11.4 | 12.3 | 13.0 | 28.6 |
| Technical Differences and Other (as above) | 3.0 | 15.1 | 2.7 | -15.5 |
| Policy Assumptions (5) | 0.0 | 6.2 | 8.0 | 8.6 |
| Outlays | 1.9 | 34.7 | 48.0 | 60.2 |
| Due to: Economic Assumptions | 1.7 | 9.5 | 23.6 | 36.8 |
| Technical Differences and Other (as above) | 0.2 | 23.0 | 18.3 | 19.8 |
| Policy Assumptions | 0.0 | 2.2 | 6.1 | 3.6 |
| Defense (6) | 0.0 | -5.0 | -10.0 | -15.0 |
| Nondefense (7) | 0.0 | 7.2 | 16.1 | 18.6 |

*(1) Estimated deficit for FY1987.*

*(2) OMB assumes a larger increase in taxable personal income and profits relative to GNP and hence a larger increase in tax receipts relative to GNP. OMB asumes the Tax Reform Act of 1986 raises revenues by $18.6 billion in FY1987 and is a "wash" in FY1988; SLB assumes a $12 billion revenue gain in FY1987 and a $15 billion loss in FY1988.*

*(3) OMB assumes higher outlays for defense, with roughly 3% real increases per year; the SLB assumption is 0%.*

*(4) OMB assumes smaller outlays for entitlements (Medicare, Medicaid, AFDC, student assistance, child nutrition, federal employee retirement benefits), farm income supports, and discretionary nondefense spending (grants-in-aid, administrative programs).*

*(5) OMB assumes revenue increases of $6.2 billion in FY1988, $8 billion in FY1989, and $8.6 billion in FY1990. Over two-thirds of the increases come from enhanced IRS enforcement and extending Medicare hospital insurance coverage to state and local employees.*

*(6) The SLB assumption is less than 0% growth in real defense outlays.*

*(7) OMB assumes much larger reductions than SLB for nondefense outlays. Beyond the effects of current law and SLB assumptions, farm price supports are trimmed an additional $2.4 billion in FY1989 and $4.1 billion in FY1990; entitlement programs are cut $3 billion in FY1988, $8.3 billion in FY1989, and $10.3 billion in FY1990; nondefense discretionary programs (user fees, loan asset sales, privatization) are trimmed $4.2 billion in FY1988, $5.4 billion in FY1989 and $4.2 billion in FY1990.*

*Source: Office of Management and Budget, January 1987; Shearson Lehman Economics*

Table 4
Meeting the Gramm-Rudman-Hollings (GRH) Targets:
Economic Impacts*
Without Compensating Monetary Easing (1)
(Differences from Baseline Forecast, in Billions of Dollars and Percentage Points, Except as Otherwise Indicated)

| | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|
| Deficit Reductions (Ex-Ante): | | | | |
| Spending (Unified Basis, Fiscal Years) | -45.5 | -68.0 | -92.5 | -105.4 |
| Defense | -22.7 | -34.0 | -46.3 | -52.6 |
| Nondefense | -11.4 | -17.0 | -23.1 | -26.4 |
| Grants-in-Aid | -11.4 | -17.0 | -23.1 | -26.4 |
| Economic Impacts: | | | | |
| Real GNP, Bils. 1982 $'s | -49.5 | -67.8 | -71.2 | -37.1 |
| (Growth, % Chg.) | -1.3 | -0.6 | -0.1 | 1.0 |
| Consumption, Bils. 1982 $'s | -6.8 | -23.1 | -31.8 | -19.7 |
| (Growth, % Chg.) | -0.3 | -0.6 | -0.3 | 0.5 |
| Bus. Fixed Invest., Bils. 1982 $'s | -7.8 | -15.9 | -16.4 | -6.6 |
| (Growth, % Chg.) | -1.6 | -1.4 | -0.1 | 1.7 |
| Net Exports, Bils. 1982 $'s | 9.0 | 28.7 | 46.9 | 60.6 |
| Fed. Govt., Bils. 1982 $'s | -30.3 | -43.5 | -57.0 | -63.0 |
| State and Local, Bils. 1982 $'s | -5.6 | -11.9 | -15.9 | -16.9 |
| Inflation-GNP Deflator, % Chg. | -0.1 | -0.3 | -0.5 | -0.4 |
| Unemployment Rate (%) | 0.4 | 0.7 | 0.7 | 0.3 |
| Housing Starts (Mils. of Units) | .020 | .068 | .129 | .159 |
| Auto Sales (Mils. of Units) | -.043 | -.063 | .044 | .192 |
| Federal Funds Rate (Basis Pts.) | -81 | -173 | -235 | -262 |
| 90-Day Treasury Bill Rate (Basis Pts.) | -70 | -141 | -175 | -199 |
| Top-Quality Corporate Bond Rate (Basis Pts.) | -93 | -166 | -214 | -257 |
| 10-Year U.S. Govt. Note (Basis Pts.) | -82 | -150 | -191 | -203 |
| Unified Budget Deficit (Ex-Post) | 34.1 | 54.3 | 86.7 | 118.3 |
| Debt Held By the Public (Bils. of $'s) | -25.4 | -81.2 | -170.1 | -297.3 |
| Net Interest on the Debt | -2.9 | -14.9 | -29.7 | -41.6 |

* Computer simulation with the Shearson Lehman Model of the U.S. Economy. Comparisons are relative to the January 1987 baseline forecast of the economy, calendar years.

The results of computer simulations with econometric models should be regarded as approximate, reflecting one of a large distribution of outcomes of the simulated changes. The more ahistorical the simulated change, the more uncertain the results.

(1) Nonborrowed reserves unchanged.

Table 5
Meeting the Gramm-Rudman-Hollings (GRH) Targets:
Economic Impacts*
With Compensating Monetary Easing (1)
(Differences from Baseline Forecast, in Billions of Dollars and Percentage Points, Except as Otherwise Indicated)

| | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|
| Deficit Reductions (Ex-Ante): | | | | |
| Spending (Unified Basis, Fiscal Years) | -45.5 | -68.0 | -92.5 | -105.4 |
| Defense | -22.7 | -34.0 | -46.3 | -52.6 |
| Nondefense | -11.4 | -17.0 | -23.1 | -26.4 |
| Grants-in-Aid | -11.4 | -17.0 | -23.1 | -26.4 |
| Economic Impacts: | | | | |
| Real GNP, Bils. 1982 $'s | 8.4 | 19.6 | 9.0 | 5.6 |
| (Growth, % Chg.) | 0.2 | 0.3 | -0.3 | -0.1 |
| Consumption, Bils. 1982 $'s | 25.7 | 34.6 | 48.0 | 26.2 |
| (Growth, % Chg.) | 1.1 | 0.3 | 0.5 | -0.8 |
| Bus. Fixed Invest., Bils. 1982 $'s | -0.3 | 15.8 | 3.1 | 22.1 |
| (Growth, % Chg.) | -0.1 | 3.0 | -2.1 | 3.3 |
| Net Exports, Bils. 1982 $'s | 7.1 | -5.7 | 22.4 | 12.4 |
| Fed. Govt., Bils. 1982 $'s | -30.3 | -43.4 | -56.5 | -61.7 |
| State and Local, Bils. 1982 $'s | -3.8 | -5.6 | -8.5 | -8.1 |
| Inflation-GNP Deflator, % Chg. | -0.1 | -0.5 | 0.4 | -0.6 |
| Unemployment Rate (%) | 0.0 | -0.3 | 0.2 | -0.2 |
| Housing Starts (Mils. of Units) | 0.258 | 0.166 | 0.128 | 0.075 |
| Auto Sales (Mils. of Units) | 0.176 | 0.443 | 0.406 | 0.559 |
| Federal Funds Rate (Basis Pts.) | -437 | -168 | -280 | 215 |
| 90-Day Treasury Bill Rate (Basis Pts.) | -341 | -146 | -245 | 192 |
| Top-Quality Corporate Bond Rate (Basis Pts.) | -184 | -95 | -208 | 150 |
| 10-Year U.S. Govt. Note (Basis Pts.) | -154 | -82 | -191 | 127 |
| Unified Budget Deficit (Ex-Post) | 90.4 | 84.2 | 167.2 | 121.7 |
| Debt Held By the Public (Bils. of $'s) | -54.8 | -87.4 | -117.9 | -213.9 |
| Net Interest on the Debt | -42.1 | -12.5 | -74.6 | -22.3 |

* Computer simulation with the Shearson Lehman Model of the U.S. Economy. Comparisons are relative to the January 1987 baseline forecast of the economy, calendar years.

The results of computer simulations with econometric models should be regarded as approximate, reflecting one of a large distribution of outcomes of the simulated changes. The more ahistorical the simulated change, the more uncertain the results.

(1) Compensating monetary easing defined as injections of nonborrowed reserves throughout the simulation period to restore real GNP to approximately its baseline path.

Table 6
Meeting the Gramm-Rudman-Hollings (GRH) Targets:
Economic Impacts*
Tax Increases and Spending Cuts, No Compensating Monetary Ease (1)
(Differences from Baseline Forecast, in Billions of Dollars and Percentage Points, Except as Otherwise Indicated)

| | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|
| Deficit Reductions (Ex-Ante): | -45.5 | -68.0 | -92.5 | -105.4 |
| Receipts (Unified Basis) | 10.0 | 20.0 | 20.0 | 20.0 |
| Spending (Unified Basis, Fiscal Years) | -35.5 | -48.0 | -72.5 | -85.4 |
| Defense | -17.7 | -24.0 | -36.3 | -42.6 |
| Nondefense | -8.9 | -12.0 | -18.1 | -21.4 |
| Grants-in-Aid | -8.9 | -12.0 | -18.1 | -21.4 |
| Economic Impacts: | | | | |
| Real GNP, Bils. 1982 $'s | -37.4 | -53.0 | -47.0 | -6.5 |
| (Growth, % Chg.) | -1.0 | -0.4 | 0.2 | 1.0 |
| Consumption, Bils. 1982 $'s | -6.4 | -21.7 | -22.0 | -5.6 |
| (Growth, % Chg.) | -0.3 | -0.5 | 0.0 | 0.6 |
| Bus. Fixed Invest., Bils. 1982 $'s | -6.1 | -11.7 | -10.3 | 1.3 |
| (Growth, % Chg.) | -1.2 | -1.0 | 0.2 | 2.0 |
| Net Exports, Bils. 1982 $'s | 7.5 | 24.3 | 40.5 | 51.7 |
| Fed. Govt., Bils. 1982 $'s | -23.7 | -30.9 | -45.1 | -51.8 |
| State and Local, Bils. 1982 $'s | -4.4 | -8.8 | -11.7 | -11.7 |
| Inflation-GNP Deflator, % Chg. | 0.2 | -0.2 | -0.4 | -0.3 |
| Unemployment Rate (%) | 0.3 | 0.5 | 0.4 | 0.1 |
| Housing Starts (Mils. of Units) | 0.021 | 0.066 | 0.115 | 0.135 |
| Auto Sales (Mils. of Units) | -0.027 | -0.029 | 0.080 | 0.224 |
| Federal Funds Rate (Basis Pts.) | -79 | -156 | -194 | -205 |
| 90-Day Treasury Bill Rate (Basis Pts.) | -58 | -114 | -144 | -154 |
| Top-Quality Corporate Bond Rate (Basis Pts.) | -66 | -131 | -209 | -235 |
| 10-Year U.S. Govt. Note (Basis Pts.) | -62 | -120 | -168 | -187 |
| Unified Budget Deficit (Ex-Post) | 26.7 | 39.0 | 71.2 | 101.7 |
| Debt Held By the Public (Bils. of $'s) | -19.8 | -61.0 | -131.2 | -239.2 |
| Net Interest on the Debt | -2.6 | -12.6 | -23.5 | -31.6 |

* Computer simulation with the Shearson Lehman Model of the U.S. Economy. Comparisons are relative to the January 1987 baseline forecast of the economy, calendar years.

The results of computer simulations with econometric models should be regarded as approximate, reflecting one of a large distribution of outcomes of the simulated changes. The more ahistorical the simulated change, the more uncertain the results.

(1) Tax increases are higher excise taxes, oil import fee ($5 a barrel) and higher cigarette and alcohol taxes.

Appendix

**Table A**
**Shearson Lehman Forecast of the U.S. Economy and Financial Markets***
**January 27, 1987**
**(Probability=0.65)**

| | Quarters | | | | | | Years | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1986:3 | 1986:4 | 1987:1 | 1987:2 | 1987:3 | 1987:4 | 1985 | 1986 | 1987 | 1988 |
| Gross National Product-1982 Dollars | 3686.4 | 3702.4 | 3720.7 | 3748.3 | 3782.1 | 3813.1 | 3585.2 | 3676.5 | 3766.4 | 3886.6 |
| Annual Rate of Change | 2.8 | 1.7 | 2.0 | 3.0 | 3.7 | 3.3 | 2.7 | 2.5 | 2.4 | 3.2 |
| Percent Change Year Ago | 2.3 | 2.2 | 1.8 | 2.4 | 2.6 | 3.0 | 2.9 | 2.2 | 3.0 | 3.3 |
| Consumption | 2448.0 | 2445.1 | 2446.3 | 2460.5 | 2480.9 | 2503.6 | 2324.5 | 2418.6 | 2472.8 | 2552.0 |
| Annual Rate of Change | 6.7 | -0.5 | 0.2 | 2.3 | 3.4 | 3.7 | 3.5 | 4.0 | 2.2 | 3.2 |
| Business Fixed Investment | 454.4 | 451.0 | 447.3 | 444.2 | 442.6 | 441.9 | 461.4 | 455.0 | 444.0 | 458.2 |
| Annual Rate of Change | -2.1 | -3.0 | -3.2 | -2.7 | -1.4 | -0.6 | 9.0 | -1.4 | -2.4 | 3.2 |
| Residential Construction | 197.2 | 199.3 | 196.1 | 194.1 | 196.5 | 198.0 | 177.3 | 193.9 | 196.2 | 199.3 |
| Inventory Investment | -0.3 | -11.5 | 14.5 | 20.2 | 23.1 | 18.7 | 9.0 | 10.8 | 19.1 | 22.3 |
| Net Exports | -163.3 | -155.6 | -140.2 | -131.8 | -123.0 | -116.8 | -108.2 | -149.7 | -128.0 | -111.1 |
| Federal Government | 330.9 | 353.5 | 333.9 | 335.8 | 336.4 | 341.4 | 323.6 | 333.4 | 336.9 | 336.2 |
| Annual Rate of Change | 2.5 | 30.2 | -20.4 | 2.3 | 0.7 | 6.1 | 10.9 | 3.0 | 1.0 | -0.2 |
| State and Local Government | 419.5 | 420.6 | 422.8 | 425.3 | 426.3 | 427.0 | 397.6 | 414.6 | 425.4 | 433.8 |
| Annual Rate of Change | 6.1 | 1.1 | 2.1 | 2.4 | 0.9 | 0.7 | 3.7 | 4.3 | 2.6 | 2.0 |
| Industrial Production (1977=1.000) | 1.250 | 1.260 | 1.271 | 1.285 | 1.301 | 1.320 | 1.245 | 1.251 | 1.294 | 1.356 |
| Annual Rate of Change | 1.9 | 3.2 | 3.5 | 4.5 | 5.1 | 6.0 | 2.3 | 0.5 | 3.5 | 4.8 |
| Housing Starts (Mil. Units) | 1.751 | 1.672 | 1.660 | 1.720 | 1.750 | 1.728 | 1.741 | 1.832 | 1.715 | 1.700 |
| Auto Sales-Total (Mil. Units) | 13.2 | 11.5 | 9.3 | 10.4 | 11.4 | 10.5 | 11.1 | 11.6 | 10.4 | 11.2 |
| Unemployment Rate-Civilian (%) | 6.9 | 6.8 | 6.8 | 6.8 | 6.7 | 6.6 | 7.2 | 7.0 | 6.7 | 6.4 |
| Federal Budget Surplus | | | | | | | | | | |
| Unified (Quarterly Rate, NSA, FY) | -53.9 | -64.4 | -46.3 | -25.3 | -53.5 | -64.6 | -211.9 | -220.7 | -189.5 | -176.0 |
| Implicit Price Deflator (%CH) | 3.6 | 1.0 | 3.1 | 3.6 | 3.5 | 3.8 | 3.3 | 2.7 | 2.9 | 3.9 |
| CPI- All Urban (%CH) | 2.6 | 2.8 | 4.0 | 3.5 | 3.9 | 4.1 | 3.5 | 1.9 | 3.1 | 4.0 |
| PPI-Finished Goods (%CH) | 0.7 | 3.4 | 4.5 | 4.2 | 4.7 | 5.0 | 0.9 | -1.4 | 3.2 | 4.2 |
| Hourly Earnings (%CH) | 1.2 | 3.1 | 2.3 | 2.9 | 3.2 | 3.3 | 3.0 | 2.4 | 2.6 | 3.2 |
| Trade-Weighted Exchange Rate | 1.028 | 1.027 | 0.979 | 0.971 | 0.979 | 0.990 | 1.272 | 1.060 | 0.980 | 1.030 |
| Annual Rate of Change | -14.3 | -0.3 | -17.4 | -3.2 | 3.3 | 4.6 | 4.0 | -16.7 | -7.6 | 6.0 |
| Merchandise Trade Balance (Bils. $'s) | -175.6 | -173.2 | -141.8 | -136.9 | -131.9 | -124.3 | -148.5 | -171.1 | -133.7 | -115.0 |
| Corporate Profits Aftertax (Bils. $'s) | 135.9 | 139.0 | 129.4 | 135.2 | 141.8 | 145.5 | 131.4 | 132.7 | 138.0 | 148.4 |
| Percent Change Year Ago | 1.9 | -0.3 | 2.0 | 5.0 | 4.3 | 4.7 | -6.3 | 1.0 | 4.0 | 7.9 |
| Adjusted Profits Aftertax (Bils. $'s) | 197.5 | 190.5 | 180.9 | 185.7 | 191.3 | 194.0 | 188.9 | 195.7 | 188.8 | 198.8 |
| Percent Change Year Ago | -1.5 | 0.7 | -9.9 | -4.4 | -3.1 | 1.8 | 11.6 | 3.6 | -4.0 | 5.8 |
| Real Disposable Income (Bils. $'s) | 2605.6 | 2602.4 | 2636.8 | 2661.3 | 2688.2 | 2717.3 | 2528.0 | 2603.8 | 2675.0 | 2777.2 |
| Annual Rate of Change | -3.0 | -0.5 | 5.4 | 3.8 | 4.1 | 4.4 | 2.4 | 3.0 | 2.8 | 3.8 |
| Personal Saving Rate (%) | 3.1 | 2.7 | 3.9 | 4.1 | 4.3 | 4.4 | 4.8 | 4.0 | 4.2 | 4.6 |
| M2 (Bils. $'s) | 2721.4 | 2783.7 | 2837.8 | 2884.7 | 2937.9 | 2998.7 | 2551.7 | 2783.7 | 2998.7 | 3232.9 |
| Annual Rate of Change | 11.6 | 9.5 | 8.0 | 6.8 | 7.6 | 8.5 | 8.8 | 9.1 | 7.7 | 7.8 |
| Prime Rate (%) | 7.85 | 7.50 | 7.50 | 7.08 | 7.00 | 7.25 | 9.94 | 8.33 | 7.21 | 7.88 |
| Federal Funds Rate (%) | 6.21 | 6.27 | 5.93 | 5.56 | 5.85 | 6.15 | 8.10 | 6.81 | 5.87 | 6.38 |
| 3-Month Treasury Bill (%) | 5.52 | 5.35 | 5.46 | 5.21 | 5.27 | 5.44 | 7.48 | 5.98 | 5.35 | 5.78 |
| 10-Year Treasury Bond (%) | 7.31 | 7.26 | 7.14 | 6.95 | 7.11 | 7.34 | 10.62 | 7.68 | 7.14 | 7.57 |
| 30-Year Treasury Bond (%) | 7.41 | 7.53 | 7.47 | 7.25 | 7..5 | 7.60 | 10.79 | 7.80 | 7.42 | 7.81 |
| New AAA-Equiv. Corporate Bonds (%) | 8.56 | 8.44 | 8.35 | 8.02 | 8.21 | 8.48 | 11.03 | 8.65 | 8.27 | 8.68 |
| Bond Buyer Index (%) | 7.28 | 6.93 | 6.77 | 6.60 | 6.75 | 6.98 | 9.11 | 7.32 | 6.78 | 7.15 |
| S&P Index of 500 Common Stocks | 241.15 | 242.97 | 269.12 | 282.12 | 289.93 | 287.36 | 189.59 | 236.17 | 282.13 | 294.29 |
| Annual Rate of Change | 1.0 | 3.1 | 50.5 | 20.8 | 11.5 | -3.5 | 18.2 | 24.6 | 19.5 | 4.3 |
| Earnings Per Share - S&P 500 ($) | 3.85 | 2.94 | 3.57 | 3.78 | 4.20 | 4.32 | 14.61 | 14.43 | 15.87 | 17.85 |
| Price-Earnings Ratio - S&P 500 | 16.3 | 16.8 | 19.0 | 20.0 | 20.0 | 18.1 | 13.0 | 16.4 | 17.8 | 16.5 |

*Includes estimated effects of Tax Reform Act of 1986

## Forecast Assumptions—U.S. Economy and Financial Markets

**Fiscal policy—budget and taxes:** With or without the Gramm-Rudman-Hollings statute, fiscal policy is no longer providing much stimulus to the economy. Under the Shearson Lehman economic outlook and current law, the deficits without GRH would be $210 billion, $205 billion, and $195 billion for FY1988 to FY1990. The averages of the Administration and CBO forecasts as of January 1987 are $160 billion for FY1988, $155 billion for FY1989, and $130 billion for FY1990.

Even with $30 billion in budget savings from the revenue gains of tax reform, the 1986 Reconciliation Act and other changes, the budget deficit is estimated by CBO and the Administration to be near $175 billion in FY1987. In FY1988, the Administration projects a deficit of $107.7 billion, just under the GRH target. The CBO estimate is $135-to-$140 billion.

Given over-optimistic economic assumptions by the government, deficit reductions that may not be bona fide, and underestimates of defense and agriculture spending, the Shearson Lehman forecast of the FY1987 unified budget deficit is $189.5 billion. For FY1988, the forecast is $176 billion, assuming about $35 billion reductions in spending.

The deficits over the next few years are likely to be well above the GRH targets, even with $30-to-$35 billion in achieved savings. Under OMB and CBO assumptions, the required cuts from FY1988 to FY1990 would be $52 billion, $83 billion, and $94 billion, respectively. Under Shearson Lehman's less optimistic current services baseline the necessary cuts are even larger at $102 billion, $133 billion, and $159 billion from FY1988 to FY1990. Such cuts are huge and improbable. Bona fide reductions of about $35 billion in FY1988, $40 billion in FY1989 and $54 billion in FY1990 are assumed.

Over five years, the Tax Reform Act of 1986 is essentially growth-neutral for the economy. But, near term, a net $14 billion tax increase (about a $33 billion tax hike on business and about a $19 billion tax cut for households) for calendar 1987 will be restrictive, with negatives on business capital spending and commercial construction outweighing the positive effects on consumption.

Real economic growth in 1987 is 0.5 percentage points lower than otherwise because of the tax bill, especially in the first half. Growth should be higher in 1988 and 1989, by 0.3 and 0.2 percentage points, respectively, because taxes, net, are reduced. Growth in business fixed investment is two percentage points lower in 1987 from the tax bill, then returns to the pre-tax bill track. Consumer spending picks up in the second half of 1987 and in 1988 as a result of the tax bill. Corporate aftertax profits are weaker in 1986 and 1987 from the tax bill.

**Monetary policy:** Accommodative through the remainder of the year and next because of sluggish growth in the U.S. and world economies. With elevated concern over the dollar, the central bank is seen as reluctant to ease without interest rates moving lower in the countries of major trading partners. Along with economic growth, the dollar is fundamental for the Fed. Real GNP growth of 1-1/2% or less is the dividing line between further easing or holding on policy. One more discount rate cut is assumed to occur in the second quarter.

**Policy mix:** The "loose fiscal-tight money" policy mix in place from 1981 to 1985 has shifted. Fiscal policy is being gradually tightened and monetary policy has been easier. The reductions of the budget deficits set into motion over 1982 to 1985 and the suspension of monetary growth targeting have produced a permanently lower profile of interest rates, higher equity prices, and a weaker dollar than otherwise would have been the case. Over time, if the twist in the policy mix is maintained, a rebalancing of the economy's imbalances should occur, with interest- and dollar-sensitive sectors such as trade, net exports, and manufacturing all performing better.

**Oil prices:** More stable oil markets over the next few months, with crude oil prices settling between $17 and $19 per barrel for North Sea Brent and West Texas Intermediate crudes and near $17 a barrel for refiners' acquisition costs. The new OPEC Agreement holds through midyear and a new one is set thereafter. The $11 a barrel net drop in refiners' acquisition costs since last November now assumed reduced inflation by several percentage points in 1986, fully offsetting the inflationary effects of a lower dollar. A deflationary effect on business costs lingers in 1987, but inflation rates rise from the latest crude oil price hikes, the declines in the dollar, and a stronger economy. A range of $16 to $19 a barrel is projected for oil prices in 1987, $18 to $21 a barrel in 1988, and $20 to $23 a barrel in 1989.

**Commodity prices:** A firming of basic commodities prices as the industrial sector revives but no surge of inflation, reflecting the still large supplies and slack demands in economies throughout the world.

**Wages and unit labor costs:** In general, continuing modest rises in wages because of economic slack, the effects of deregulation, intense product and labor market competition, and the decline in union strength. A tough stance by management is assumed to keep rises in wages on a low track. Productivity growth should pick up with increased industrial output and benefit from the lower energy prices, net, in 1986-87. Unit labor cost increases of 1.5% to 2.5% per annum for 1987 and 1988 are expected. These small rises in labor costs are a major factor in the subdued inflation that appears in the forecast.

**Third World debt and bank problems:** Major debtors turn to the banks to negotiate new loans in 1987, notably Brazil, Argentina and the Philippines. Mexico should start negotiations in mid-1987 for 1988 borrowing needs. South Korea will leave the list of problem countries as its current account balance moves firmly into surplus. Bank balance sheets and debtor countries' problems should be eased from a trend to swap debt for equity, and eventually to securitize LDC loans. Banks will continue to build up reserves against loans to the big debtors. Growth in the developed world is not sufficient to rally energy or commodity prices, and a slowdown in U.S. imports assures that LDC liquidity problems will remain.

**Growth in the rest-of-the-world economies:** With sluggish growth abroad, pressure continues on Germany and the Japanese to undertake more expansionary policies, open their economies, and continue lowering interest rates. Growth is weak but somewhat better in Japan in 1987 and still sluggish in Germany. Unemployment declines a little in Europe, but continues to be a major economic problem. In Japan, unemployment will rise to record highs. Another round of lower interest rates abroad is assumed in the first half of 1987.

**The dollar and trade legislation:** The fundamentals point to a lower dollar yet, with fluctuations between 1.7 and 1.9 deutschemarks, from 145 to 155 yen, 6 to 6-1/4 French francs, and 1.50 to 1.55 on the British pound sterling. A 5%-to-10% drop against the Morgan Guaranty trade-weighted exchange rate is expected by mid-1987 compared with 1986 averages, but the dollar at year-end should be stronger than at mid-1987. The strong currencies for the U.S.'s major trading partners have permitted some easing of monetary policies and helped to lower interest rates. But, if further interest rate reductions do not occur abroad and the U.S. trade deficit does not show a significant improvement, the dollar will push even lower, heading for 1.6 deutschemarks, 135 yen, less than 6 francs, and 1.60 or more on the pound sterling.

Trade frictions are assumed to mount in 1987. Protectionist legislation occurs by mid-year, but not in a severe form as a compromise between a Senate trade bill and Administration proposals is reached.

**Table II**
**World Outlook Summary**
**(History and Shearson Lehman Forecast)**
**January 27, 1987**

| | Real Growth* (Percent Change) | | | | Inflation- Consumer Prices (Percent Change) | | | | Unemployment Rate (Percent) | | | | Current Account Balance** (Billions of U.S. Dollars) | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1984 | 1985 | 1986 | 1987 | 1984 | 1985 | 1986 | 1987 | 1984 | 1985 | 1986 | 1987 | 1984 | 1985 | 1986 | 1987 |
| United States | 6.6 | 2.7 | 2.6 | 2.5 | 4.3 | 3.5 | 1.9 | 3.0 | 7.5 | 7.2 | 7.0 | 6.7 | -107.4 | -117.8 | -142.7 | -107.0 |
| Canada | 5.5 | 4.0 | 3.4 | 3.1 | 4.3 | 4.0 | 4.2 | 3.4 | 11.3 | 10.5 | 9.6 | 9.2 | 2.6 | -0.4 | -6.5 | -3.2 |
| Europe | 2.3 | 2.5 | 2.4 | 2.7 | 5.9 | 5.2 | 2.5 | 3.0 | 10.5 | 10.8 | 10.9 | 10.6 | 4.7 | 14.7 | 41.0 | 21.0 |
| France | 1.5 | 1.4 | 2.4 | 3.0 | 7.7 | 5.8 | 2.5 | 2.7 | 10.0 | 10.3 | 10.4 | 9.9 | -0.8 | 0.2 | 2.6 | 5.5 |
| West Germany | 3.0 | 2.5 | 2.5 | 2.4 | 2.4 | 2.2 | -0.2 | 1.2 | 9.1 | 9.3 | 8.9 | 8.9 | 6.8 | 13.9 | 36.8 | 20.5 |
| Italy | 2.8 | 2.3 | 2.7 | 3.0 | 10.5 | 8.6 | 6.2 | 4.7 | 12.1 | 12.9 | 13.8 | 13.1 | -2.9 | -4.2 | 2.8 | -3.0 |
| United Kingdom | 1.8 | 3.8 | 2.1 | 2.6 | 5.0 | 6.1 | 3.4 | 3.6 | 11.7 | 11.8 | 11.9 | 11.6 | 1.6 | 4.8 | -0.6 | -2.0 |
| Far East | 5.7 | 4.4 | 2.8 | 3.0 | 2.8 | 2.5 | 1.7 | 1.8 | — | — | — | — | 37.0 | 55.0 | 93.7 | 82.6 |
| Japan | 5.0 | 4.7 | 2.3 | 2.7 | 2.3 | 2.0 | 0.6 | 1.1 | 2.7 | 2.6 | 2.8 | 3.2 | 35.0 | 49.2 | 84.0 | 75.0 |
| South Korea | 8.6 | 5.2 | 12.2 | 7.1 | 2.4 | 2.5 | 2.3 | 2.5 | — | — | — | — | -1.4 | -0.9 | 5.0 | 4.5 |
| Taiwan | 9.6 | 4.3 | 10.8 | 6.8 | 0.2 | 0.4 | 0.7 | 1.2 | 2.4 | 2.9 | 2.7 | 2.9 | 7.0 | 9.3 | 14.0 | 8.0 |
| Hong Kong | 9.8 | 0.8 | 5.2 | 4.8 | 4.7 | 2.6 | 4.1 | 3.7 | — | — | — | — | -0.3 | 0.5 | 0.0 | 1.0 |
| Indonesia | 5.8 | 1.0 | 0.4 | 2.5 | 10.5 | 4.7 | 5.8 | 4.8 | — | — | — | — | 5.7 | 5.8 | 2.2 | 2.5 |
| Singapore | 8.2 | -1.8 | 1.9 | 2.8 | 2.6 | 0.5 | 0.1 | 0.5 | — | — | — | — | -0.7 | -0.3 | -1.0 | -1.2 |
| Australia | 6.9 | 4.4 | 1.1 | 1.8 | 4.0 | 6.7 | 8.8 | 6.4 | 9.0 | 8.2 | 8.1 | 8.6 | -8.3 | -8.6 | -10.0 | -6.7 |
| Latin America | 3.4 | 3.9 | 2.8 | 2.9 | 195.3 | 201.9 | 102.3 | 54.6 | — | — | — | — | 6.7 | 3.1 | -7.9 | -7.0 |
| Argentina | 2.4 | -4.5 | 3.0 | 3.0 | 626.7 | 672.2 | 90.1 | 45.0 | — | — | — | — | -2.5 | -1.0 | -3.2 | -3.0 |
| Brazil | 4.5 | 8.3 | 9.1 | 4.6 | 223.8 | 235.1 | 158.6 | 72.0 | — | — | — | — | 0.0 | -0.3 | -1.2 | -1.9 |
| Mexico | 3.7 | 2.7 | -3.5 | 1.1 | 65.5 | 57.2 | 86.1 | 65.0 | — | — | — | — | 4.2 | 0.5 | -2.2 | -2.4 |
| Venezuela | -1.1 | 0.3 | -2.0 | 1.7 | 18.3 | 9.1 | 10.6 | 8.9 | — | — | — | — | 5.0 | 3.9 | -1.3 | 0.3 |
| All Countries Listed | 5.2 | 3.1 | 2.7 | 2.7 | 15.7 | 15.5 | 8.1 | 5.9 | — | — | — | — | -56.4 | -45.4 | -22.4 | -13.6 |
| OECD Countries Listed | 5.2 | 3.1 | 2.5 | 2.6 | 4.3 | 3.8 | 2.1 | 2.8 | 7.6 | 7.5 | 7.4 | 7.3 | -73.4 | -62.9 | -34.0 | -20.9 |
| EEC | 2.3 | 2.5 | 2.4 | 2.7 | 5.9 | 5.2 | 2.5 | 3.0 | 10.5 | 10.8 | 10.9 | 10.6 | 4.7 | 14.7 | 41.0 | 21.0 |

* Real GNP or GDP, depending on the country

** Hong Kong and Indonesia, trade balance

## Forecast Assumptions—Rest of the World

**France:** The Chirac Conservative government's program of denationalization and liberalization of capital markets will continue, despite labor unrest in early 1987. Conservatives are likely to wrest the presidency from the Socialists in the upcoming elections. The 1987 budget is the first in 28 years to cut real expenditures. The deficit will shrink to 2-1/2% of projected GDP in 1987 from 3% in 1986, and the government plans to reduce the deficit by Fr 15 billion in each budget to 1989. Tax reform will lower both personal and corporate rates but expand the tax base. Monetary policy shifts to interest rate management in 1987 after many years of direct credit and foreign capital controls. Targets of 3% to 5% for M2 match with anticipated 5% growth of nominal GDP, but nominal interest rates should decline somewhat to catch up with the deceleration of inflation that occurred in 1986. The franc should remain strong against the dollar, trading in the Fr 6 to Fr 6.25 range.

**Germany:** The victory of the center-right coalition in the January 25 election promises a continuation of the Kohl government's broad economic policies of fiscal and monetary conservatism. Government spending is expected to remain flat in 1987 and the deficit will be essentially unchanged from 1986 as a share of GNP. The government will propose revenue-neutral tax reform for debate in 1987 and implementation in 1988. The 1987 growth targets for Central Bank Money—set at 3% to 6%—are wider than last year, lessening the odds on any further change in monetary policy. Currency intervention early this year will keep growth in CBM high, making an additional easing in monetary policy less likely in the first half. But at some point, continuing weak real growth and external pressure should bring another easing by the Bundesbank. The deutschemark will continue to appreciate against the EMS currencies and the dollar in 1987, ranging from DM 1.7 to DM 1.9 vs. the dollar and stabilizing near DM 1.8 by year-end.

**Italy:** The Craxi coalition remains in the government, but the balance of power is too fragile to get the kinds of expenditure reductions needed to dent the public sector deficit—the overwhelming economic problem. The 1987 draft budget was not approved by January 1 but should pass Parliament early in the year. The final resolution will be considered a success if the government deficit does not exceed last year's. Interest rate reductions should catch up with the deceleration of inflation that occurred in 1986, but real rates will remain high as public financing bumps against fixed ceilings on domestic credit. The exchange rate should fluctuate between Lit 1250 and Lit 1350 against the dollar while slowly sliding against the deutschemark. The trade and current account deficits will improve in 1987 because oil prices will be lower, on average, than in 1986. Tourism will pick up again in 1987 and 1988.

**United Kingdom:** Polls indicate Thatcher's Conservatives and the Labour opposition are tied, pushing elections off until very late this year or early in 1988. Assuming a continued Tory government, the 1987/88 budget will aim to keep spending as high as the level already delivered by the autumn budget supplement. Revenues will continue to be enhanced by sales of public assets through 1989, postponing a budget crisis and allowing the promised reductions in personal tax rates for both 1987 and 1988. Monetary policy will be keyed on the value of the pound—current speculation against the sterling has pushed real interest rates higher in England than elsewhere in the developed world. Firmer oil markets in 1987 should help the sterling, allowing interest rates to drift downward later. High wage increases point to more inflation down the road, however, and are symptomatic of a major problem still facing the British economy.

**Japan:** The LDP will have to select a new leader in 1987 as Mr. Nakasone's exceptional term extension expires. The budget for fiscal 1987/88 is the most austere in 22 years with virtually no increase in overall expenditures. The stimulus of the 1986 supplemental budget will not be carried forward, unless spending is augmented in the summer. Japan remains committed to eliminating public sector borrowing by 1990. Tax reform will lower personal and corporate tax rates, but new taxes and fees will balance the program and leave revenues unaffected. Monetary policy is not a top priority, and the monetary growth target will remain around 8% through 1988 despite low inflation and sluggish growth. Official short-term interest rates have been pushed quite low, but long-term rates can ease. The Bank of Japan will intervene as needed to try and hold the exchange rate between ¥150 and ¥160 to the dollar. But, if the U.S. deficit does not improve early in 1987, the exchange rate would slip to ¥145 or so.

**Canada:** With no impending governmental crises, the Mulroney government is relatively free to address the issues of unemployment, the public sector deficit, and trade. The FY1986/87 budget fell short of its goal to bring public borrowing under C$30 billion, and the FY 1987/88 budget can improve on that performance only by cutting expenditures—a difficult task with high unemployment. Tax reform is under study, but will not likely become reality until 1988 when U.S. tax reform comes into full force. Monetary policy is committed to defending the Canadian dollar, and short-term interest rates could rise early in 1987 as pre-budget speculation mounts. After the defense of the currency, interest rates should move in parallel with U.S. rates, although the spreads would widen if the exchange rate remains unchanged. Trade negotiations with the United States will produce disappointing results in 1987—small issues will continue to cloud overall trade relations.

**East Asia:** The stellar growth of 1986 will continue at a slightly dampened pace in 1987 and 1988. Taiwan will see foreign demand slacken in 1987 and 1988 as the U.S. and Japan cut back on import demand. South Korea should have another strong year as new industries open up export opportunities—especially in cars and electronics—and export-led growth continues. Hong Kong should benefit from China's improved import position. Generally, exports should lead this economy up as well. Singapore's recovery from the 1985-86 recession will solidify in 1987, but exports will not be strong enough to return the country to its historically high growth rates.

**Latin America:** Mexico will elect a new president in 1988 and politics could turn less flexible to the country's creditors as early as 1987. National elections are also expected in Brazil and Argentina within the next 18 months. Economic restructuring plans are disintegrating in both economies, and external deficits are widening. In 1987, new loan requests considered by the world banking community will be resolved on a case-by-case basis, but most banks will be reluctant and ungenerous lenders. Inflation is accelerating in all of the major Latin economies. Debt-for-equity swaps will be the dominant source of new lending over the next two years through the discount market, and some form of securitization of LDC debt will be implemented. Commercial banks will continue to increase reserves against Latin American loans.

**Table C**
**Recent History and Prospects for the U.S. and World Economy**
**Exchange Rates and Interest Rates**
**January 27, 1987**

| | 1985:1 | 1985:2 | 1985:3 | 1985:4 | 1986:1 | 1986:2 | 1986:3 | 1986:4 | 1987:1F | 1987:2F | 1987:3F | 1987:4F | 1985 | 1986 | 1987F |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Exchange Rates** | | | | | | | | | | | | | | | |
| United States (Weighted Avg.) | 1.350 | 1.313 | 1.249 | 1.173 | 1.117 | 1.067 | 1.028 | 1.027 | 0.979 | 0.971 | 0.979 | 0.990 | 1.271 | 1.060 | 0.980 |
| Japan (¥ per $) | 257.5 | 250.8 | 238.4 | 207.2 | 187.8 | 169.9 | 155.8 | 160.5 | 152.0 | 148.2 | 145.1 | 147.0 | 238.5 | 168.5 | 148.1 |
| West Germany (DM per $) | 3.257 | 3.089 | 2.847 | 2.584 | 2.348 | 2.245 | 2.085 | 2.006 | 1.781 | 1.741 | 1.705 | 1.788 | 2.944 | 2.171 | 1.754 |
| France (Fr per $) | 9.958 | 9.422 | 8.681 | 7.886 | 7.212 | 7.141 | 6.779 | 6.571 | 6.001 | 5.710 | 5.652 | 5.781 | 8.987 | 6.926 | 5.786 |
| United Kingdom ($ per £) | 1.115 | 1.256 | 1.376 | 1.435 | 1.441 | 1.509 | 1.488 | 1.430 | 1.532 | 1.571 | 1.600 | 1.575 | 1.296 | 1.467 | 1.570 |
| Canada (C$ per US$) | 1.35 | 1.37 | 1.36 | 1.38 | 1.40 | 1.39 | 1.39 | 1.39 | 1.36 | 1.34 | 1.34 | 1.35 | 1.37 | 1.39 | 1.35 |
| **Short-Term Rates** | | | | | | | | | | | | | | | |
| United States | 8.2 | 7.5 | 7.1 | 7.2 | 6.9 | 6.1 | 5.5 | 5.4 | 5.4 | 5.2 | 5.2 | 5.4 | 7.5 | 6.0 | 5.3 |
| Japan | 6.3 | 6.3 | 6.3 | 7.0 | 6.0 | 4.7 | 4.6 | 4.6 | 3.9 | 3.8 | 3.8 | 4.0 | 6.5 | 5.0 | 3.9 |
| West Germany | 6.1 | 5.8 | 4.9 | 4.8 | 4.6 | 4.6 | 4.5 | 4.6 | 4.3 | 4.1 | 4.0 | 4.2 | 5.4 | 4.6 | 4.2 |
| France | 10.6 | 10.3 | 9.8 | 9.1 | 8.7 | 7.4 | 7.1 | 7.4 | 8.4 | 8.2 | 7.8 | 7.9 | 9.9 | 7.7 | 8.0 |
| United Kingdom | 12.4 | 11.9 | 11.0 | 11.2 | 11.6 | 9.5 | 9.6 | 10.2 | 10.9 | 10.5 | 10.3 | 10.4 | 11.6 | 10.2 | 8.1 |
| Canada | 10.4 | 9.5 | 8.9 | 8.9 | 10.8 | 8.5 | 8.4 | 8.4 | 8.6 | 8.2 | 7.9 | 8.0 | 9.4 | 9.0 | 8.2 |
| **Long-Term Bond Yields** | | | | | | | | | | | | | | | |
| United States | 11.6 | 11.0 | 10.6 | 10.0 | 8.8 | 7.5 | 7.6 | 7.5 | 7.5 | 7.3 | 7.4 | 7.6 | 10.8 | 7.8 | 7.4 |
| Japan | 6.6 | 6.4 | 6.1 | 6.3 | 5.2 | 4.9 | 5.1 | 5.3 | 5.1 | 4.9 | 4.8 | 4.9 | 6.3 | 5.1 | 4.9 |
| West Germany | 7.4 | 7.1 | 6.5 | 6.5 | 6.1 | 5.7 | 6.1 | 6.1 | 5.8 | 5.6 | 5.5 | 5.6 | 6.9 | 6.0 | 5.6 |
| France | 12.2 | 11.7 | 11.7 | 11.3 | 10.3 | 8.2 | 7.9 | 8.1 | 8.5 | 8.4 | 8.1 | 8.2 | 11.7 | 8.6 | 8.3 |
| United Kingdom | 10.3 | 10.3 | 9.9 | 9.9 | 9.5 | 8.7 | 9.5 | 10.1 | 10.4 | 10.2 | 10.0 | 10.1 | 10.1 | 9.5 | 10.2 |
| Canada | 11.9 | 11.0 | 10.9 | 10.4 | 10.0 | 9.4 | 8.9 | 8.9 | 8.3 | 8.4 | 8.2 | 8.3 | 11.0 | 9.3 | 8.3 |

Notes: Data are period averages; annual data are averages of quarterly values. *Short-term rates:* United States—3-month Treasury bill yield; Japan—Gensaki 3-month rate; West Germany—3-month bill rate; France—3-month government note (pension); United Kingdom—91-day Treasury bill yield; Canada—3-month Treasury bill rate. *Long-term rates:* United States—average yield on government bonds with 30-year maturity; Japan—yield on benchmark 10-year bond; West Germany—yield on most recent issue 10-year bond; France—average yield on 10-year government bonds; United Kingdom—yield on 10-year gilts; Canada—yield on 10-year government bonds.

*Source:* History—OECD Main Economic Indicators and Shearson Lehman Economics; Forecast—Shearson Lehman Economics.

Chairman ROSTENKOWSKI. Dr. Eisner, you may proceed.

**STATEMENT OF ROBERT EISNER, PH.D., WILLIAM R. KENAN PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY**

Mr. EISNER. I am Robert Eisner, professor of economics from Northwestern University, the great State of our chairman.

I will pick up a bit on what my colleagues said, and I would like to also pick up on the challenge of the chairman in indicating that our concern must be with where the economy is, and what the impact of the budget and budget deficit is on the economy.

I would like to say here that there is a good bit about the conventional wisdom which doesn't ring true. If we adjust the deficit over the years for inflation, we get a real budget deficit—as described in my book, which I recommend to all of you. You will find that over the years, over the last two or three decades, bigger structural budget deficits, contrary to what people may say, have been associated with subsequent greater growth in the economy.

In fact, I wouldn't put an exact figure on any of this, but you will find over a 25-year period, each $10 billion in structural, inflation-adjusted budget deficit is associated with a growth of some $15 billion in GNP, the following year and as GNP grows, unemployment goes down.

Now, those are facts. They may relate to the fact that we had a lot of slack, a lot of unemployment for some of this period, and therefore, there was room for the economy to grow in the face of fiscal stimulus.

Where I may depart from a lot of people is in the stress I place on what I consider to be the current situation. You have to recognize that we have 6.7 unemployment, over 8 million unemployed, and whole States and areas depressed. The rate of growth of real GNP is down to some 2.2 percent with none of my colleagues really forecasting anything much better.

In that state of the economy, what are the greatest dangers? What should we be doing? What are the risks that we can evaluate? The budget deficit is too large, in terms of what it might be in an ideal situation with full employment, with an appropriate monetary policy, but there are many things much worse than the budget deficit, including many of the ways proposed to reduce it, the speed at which it would be reduced and adherence to anything remotely resembling the rather hideous Gramm-Rudman targets.

Budget deficits can be too large. They can also then be too small. The thing that we have to remember is that the pie of our economy is not fixed.

There have been references this morning to a pool of national savings. There is no fixed pool of national saving. The saving varies with the state of the economy. We have been told, for example, that our budget deficit is being financed from abroad. Somehow, if that financing from abroad were eliminated, our domestic investment would have to go down.

But domestic investment depends very much on the state of the economy, overwhelmingly so, and depends upon the growth of GNP.

The budget deficits that we have had in the past, structural deficits, inflation-adjusted, have been associated with greater growth in GNP. People will say, but the budget deficits finance increased consumption and that must deprive us of investment.

The fact is precisely the opposite. When we have had bigger budget deficits and greater growth in GNP, we have had greater growth in consumption and greater growth in investment.

Those are the realities that we have to face: Reducing the budget deficit in the aggregate, unless it is accompanied by a much easier monetary policy, and you are likely to have—we can never be sure of anything as economists—you are likely to have a worse off economy, greater unemployment, less growth.

I can't be sure of that, and my colleagues can't be sure of that, so the question is what risks do you want to take? What is a greater thing to worry about, the size of the budget deficit in dollars or the size of the economy in real output of goods and services?

There are a number of things that are particularly phony about the budget deficit as presented to us, and one of the things is, for example, the matter of sale of assets. In a real sense, the deficit impacts the economy by affecting the wealth of the private sector.

When the Federal Government runs a deficit, the private sector ends up with more Government bonds, which makes you feel wealthier and makes you spend more.

That is the effect of a real deficit. You do not alter that by selling off Government assets, by a curious method of Government accounting dissimilar from private accounting, or State and local government accounting. We may have that impression, but there is no real change there.

The objection to the fixed budget deficit targets, as has been suggested again by Dr. Sinai, is they don't take into account the impact of the state of the economy, and that can be a very serious issue.

I want to strike out perhaps even more fundamentally—and I hope I don't shock some of you. There is nothing sacred or correct about a balanced budget, whatever Gramm-Rudman says, whatever the President says; you as individuals don't have to balance your budget. I won't call it a lie, it is just not true. People don't balance their budgets. You as individuals don't. In fact—I shouldn't use such strong language—the American people would be idiots if they all tried to balance their budget. If they balanced their budget they would not be buying homes, would not be investing in the education of their children. There is nothing wrong about an unbalanced budget for the individual. Almost every private business has an unbalanced budget.

You have in the back of my prepared statement a table on what happens to GM and IBM, for example, over the years, and they keep, two of our largest, most successful companies, they keep running deficits, they keep increasing their debt.

Now, if there is nothing sacred about a balanced budget, and most people don't have balanced budgets, what should be the target of the Federal Government with regard to its budget? Here I have to say, to begin with, the Federal Government has a particular responsibility. It is not to meet some dogma about balancing budgets. Its responsibility is the economy of the United States and the ques-

tion then is, will reducing the deficit at any time help the economy or hurt it?

If there is slack in the economy, if there is excess unemployment, reducing the budget deficit, no matter how you do it, by raising taxes or cutting spending, will in itself aggravate the slack and depress the economy further.

The only time, by the way, you would clearly want to reduce a deficit in terms of its overall effects is where you have too much demand—you have excess spending—which is creating inflation.

Again, rhetoric aside, look at the current situation. Let's not fight the last war. Inflation is virtually zero. We can say it may heat up. All kinds of things may happen. The fact is we have virtually zero inflation now.

We have no evidence of excess demand, and we still have presumably 4 years or so of recovery.

We still have the unemployment which until this current administration would always have to be considered excessive and intolerable and I believe it is still intolerable. That should be an essential part of our focus.

Back to the question of the balanced budget, and what our ultimate target should be. I would suggest that we recognize again, as I indicated, that the impact of a deficit is to raise the debt. Now, you might say we should not be going more and more in debt, but that doesn't really hold up, and doesn't make sense either. Private individuals and companies, as I said, are all going more and more into debt.

We really mean if we think about it, we shouldn't go too much into debt. But what is too much into debt? That relates to our income. If one of us had borrowed $50,000 to buy a house 25 years ago, when our income was $15,000, that would have seemed like a substantial debt. Well now the person's income is $40,000, $50,000 is not much of a debt relative to what it was before.

The same thing in a sense is true for the Federal Government. One litmus paper, one measuring rod, would be the ratio of the debt to the GNP. Now, by that standard, as well, the deficits have been large in the last 6 years. The ratio of debt to GNP has grown enormously. But that has to be taken in perspective. From 1946 to 1980, the ratio of debt to GNP fell enormously. It is still considerably less than it was at the end of World War II.

In a growing economy, what would be a balance for the Government? I would suggest that a balance to begin with is keeping that debt from growing faster than our income, just as indeed it would be for an individual or a company. That is not necessarily an absolute target, but that would be the kind of a measure of true balance, that debt not grow more rapidly than the GNP.

Well, how fast is GNP growing? The administration budget, the CBO, everybody else forecasts a growth in GNP of about 6 percent a year. Let's take a figure of 6 percent a year. Let's take a round number now. My prepared statement is not quite as round. Let's say the GNP is $4,000 billion. It is a bit more, but $4,000 billion. The debt is about $2,000 billion, also a bit more. But the debt is half of GNP.

Now, if the GNP grows at 6 percent, that means that the debt can grow at 6 percent and you still keep that balance—$4,000 plus

6 percent would be $4,240; $2,000 plus 6 percent would be $2,120. Still half.

That means what? That to keep the debt growing at the same rate as GNP you could have a deficit actually with an estimated figure of $4,000 billion of GNP for 1987. You could have a deficit of $132 billion and still have the same ratio of debt to GNP.

Indeed, if Messrs. Gramm, Rudman, and Hollings had thought through the economics on a more sober note, without any of the politics or dogma or appealing to prejudice, they might have said a responsible posture is to keep the debt from growing beyond the GNP, and that would have meant that as long as the GNP is growing at 6 percent a year, the deficit can be 3 percent a year given the fact we are starting with a debt ratio, debt-to-GNP ratio, of 50 percent. Now, that then means current figures, a deficit of $132 billion, if you get out to 1990-91, when Gramm-Rudman says you should have a balanced budget, that would imply a deficit of about $180 billion.

Those are sensible starting points. Whether those deficits are too large or too small, as my colleagues are suggesting, though we apparently have no evaluation of the risk, whether those targets are wise or not, depends upon what the impact is on the economy.

I have a few more things I would like to emphasize quickly. One is, as Dr. Sinai suggested, in particular, monetary policy is critical. You cannot decide on what your budget deficit should be until you recognize what the monetary policy is, what it will be, and there are two important aspects of that.

One has been suggested—an easier monetary policy by a lowering of interest rates will directly reduce the measured deficit, and if you can count on that monetary policy easing, you can lower your deficit projections right there. And while that is not directly the province of the Ways and Means Committee, I must say, that that should clearly be understood and that should be the emphasis of the Congress that a critical way of reducing the deficit is ending this curious policy of having a fiscal policy thought to be stimulative, balanced by a monetary policy which, while much more relaxed than it has been, is still unduly cautious.

There is a second aspect in which monetary policy will be critical, not only in directly reducing the measured actual cyclical budget deficit, but in stimulating the economy and driving down the value of the dollar. You will have an enormous effect in reducing the actual deficit, and eliminating the malaise in the economy.

I might add I think there has been much misunderstanding of the relationship between the budget deficit and the trade deficit. It is true that budget deficits probably do contribute—although economists differ how much—contribute to somewhat higher rates of interest. They would do it mainly in a period where you have a rather full employment, superheated economy, but in general, we are saying budget deficits may tend to raise interest rates. That will drive up the value of the dollar, that will cause, as Dr. Schultze pointed out, a trade deficit and foreign capital coming in.

I must add that we keep talking about a debt. This surplus of imports of foreign capital is not necessarily a debt. I don't have the figures handy, but I doubt most of it is debt. It is investment by foreign countries in the United States, investment in assets, wheth-

er it is motels or new automobile plants, or what have you, and not all of that is bad. It is a direct investment.

It is true that foreigners may then be accumulating dividends and earnings, but we are getting the added productivity and the added worth that they contribute to creating. However, if we are concerned about the trade deficits—I think we should be—we should see that the reason for the trade deficit essentially is the high value of the dollar. The way to drive down the high value of the dollar is not to fool around and say we have to cut the deficit. The way to drive down the high value of the dollar is a very simple matter of economics.

The value of the dollar, like most other things is a matter of supply and demand. You have to supply more dollars and the Federal Reserve can supply all the dollars it wants, it can supply millions and billions and it doesn't need any agreement with Japan or anybody else.

As has been pointed out by the other people on the panel, while the dollar has come down, it is still well above what it was in 1980. It is most elementary economics that when the price goes high, the demand goes low, and as long as the dollar is high, we shouldn't be surprised that our exports have had trouble competing with exports of other countries and competing in the rest of the world.

Finally, on cutting the deficit, and how you do it, and the nature of the President's budget specifically. There is a lot of talk about deficits reducing investment. There is talk about the deficit creating a burden on future generations. Let's get one thing clear. There is one way and one way only that we put a burden on our children or our future generations, and that is by not bequeathing them capital which is productive, by making them less able to produce in the future.

Budget deficits can contribute to that by discouraging private investment. As I pointed out, in fact, our budget deficits have not discouraged private investment. It is true if you assume a full employment economy, then you might argue, particularly if monetary policy is not expansive, that the budget deficit might be discouraging private investment. It has not in fact done that.

Moreover, if your concern is investment, and therefore the impact on future generations, you have to remember that private investment, particularly by business, is only a small part of total investment in the economy. The bulk of the investment is not by private business—and this is no slur on private business—the bulk of investment is not that machinery and equipment that business acquired or the buildings they set up, it is the huge amount of public capital and very largely human capital.

If you are concerned then with investment, with future generations, it is perhaps idiocy to say we have to cut the deficit in order to not hurt future generations and then cut the deficit by not keeping up our roads, our bridges, our harbors, our airports, our minerals, and most of all, the health and education of our people.

The President's budget is going to cut the education by some 25 percent, as I recall. That makes no sense in terms of the overall argument. If you are concerned with the burden on future generations there is no way you can put a bigger burden on them than by

leaving them ill educated and ill endowed with human physical capital, which will be essential for production in the future.

I had in my prepared statement a reference or two to tax matters, which are close to my heart. I might just mention them, and be happy to put into the record any documents you want, but I would hope that this committee would not go back on any of the excellent work it did in the last Congress in eliminating some of the so-called tax incentives for investment. I think they were misguided, particularly eliminating the investment tax credit was wise. You got rid of it and I would add that the research and development credit, which you reduced and kept temporary, which I spent a good bit of time studying, and which people would now like to make permanent, and reexpand, was a perverse monstrosity that did little to encourage research and development in general.

I would caution about being taken in by proposals of various interested groups, perhaps faced with a problem or two of a slack economy, to say the way to help the economy is to give them this or that tax break and that will make them more productive.

So, with that happy thought, I close.

[The prepared statement follows:]

2/06/87

**An Overview of the FY 1988 Budget**
**Prepared Statement of Robert Eisner***

**Committee on Ways and Means**
**U. S. House of Representatives**
**February 11, 1987**

## 1. Introduction and Summary

There is much wrong with the Administration's 1988 budget. It is deceptive, unrealistic, and misguided in its priorities. If implemented it would cause serious economic damage, both in the short run and for years to come.

The real, current deficit may well be too large. But the highest priority of the Congress should not be mechanical deficit reduction. It should rather be to put in place public policies to get our economy moving again, to provide for our true current needs and to invest in our future.

Deficits can be too small as well as too large. To know which, we have to measure them right. And we have to take into account the current and prospective state of the economy and monetary policy. Past structural deficits have in fact contributed to greater growth, less unemployment and more, rather than less, private investment.

As aggressive easing of monetary policy drives down real interest rates and the exchange value of the dollar, thus stimulating investment and reducing our huge trade deficit by raising exports, the budget deficit should be reduced. But in the current economic situation, the fiscal 1988 deficit target of $108 billion is a dangerous gamble with our economic future.

The fixed deficit targets required by Gramm-Rudman generally threaten both reasonable economic growth and stability. And a balanced budget in 1991, particularly given the eccentricities of federal accounting, is not desirable and is probably not feasible.

The first-order effects of raising revenues and of reducing outlays are fairly similar. There is not much difference, for example, between reducing black-lung benefits and taxing them. Reducing outlays for goods and services, however, would generally have a greater impact in reducing aggregate demand than would either reductions in transfer payments or increases in revenues. Reduction in investment-type expenditures would have long run impacts on economic growth.

Whatever the vice or virtue in "privatization," selling government assets is clearly a phony way to reduce the deficit. It in no way reduces the real deficit and hence does nothing to alter its real impact.

Appropriate public policies for economic growth and competitiveness must include providing adequate aggregate demand for all of the goods and services that can be produced in a full-employment economy. They should seek to secure essential investment in public capital and above all in the human capital on which prosperity and growth depend. They should not include distortionary "tax incentives," such as those for investment and research and development which this Committee and the last Congress wisely did a great deal to curb or eliminate.

## 2. The fiscal 1988 deficit target of $108 billion

Rhetoric aside, the budget must be evaluated in terms of its impact on the economy. The critical fact is the accounting identity that government budget deficits must equal private budget surpluses. Where the government is a debtor, the private sector — and foreigners — are creditors. The great bulk of government debt is owned here at home. The more we own of that debt, paradoxical as it may seem, the wealthier we feel and the more we are inclined to spend.

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Deficits can then be too large if they increase private spending to the point where total spending, public and private, is more than the economy can readily produce. The result is inflation, in itself painful. Efforts to combat the inflation by tight money raise interest rates which in turn curb investment. Reduced investment is then the way -- and the only way -- that a real burden is put on our children and grandchildren.

If there is insufficient purchasing power or demand, from our private sector, from government and from foreigners, production, employment and our standard of living are all depressed. In such a situation, failing some other solution, it may well be argued that the deficit is too small. For here a government deficit, by adding to private wealth and purchasing power, increases private demand and hence contributes to raising production and putting people back to work.

The record until recent years suggest that deficits have generally been not too large but rather too small. This becomes particularly clear when account is taken of the effects of inflation, which by reducing the real value of the money and bonds held by the public, acts as a tax which in a very real sense reduces the economically relevant real deficit. The inflation tax has frequently been so large as to convert our purported deficits into real surpluses.

A few charts (taken from my recent book, How Real Is the Federal Deficit?) tell the story very clearly. Larger real, structural or "high-employment" budget deficits have been associated with greater subsequent growth in real GNP and declines in unemployment. And with greater growth in GNP have come increases in private investment. Deficits in fact have not crowded out investment; they have crowded it in.

In the light of this what can we say about the fiscal 1988 proposal to reduce the deficit to the Gramm-Rudman target of $108 billion? To answer this question we must note that GNP growth for last year was slow, some 2.2 percent. The consensus of private forecasters is that growth in 1987 will not be much better. Official figures for the totally unemployed continue at 6.7 percent of the labor force. Investment demand is depressed both by the slow growth and the persistence of high real interest rates.

The budget deficits we have had have been enormous. We must face reality, however, and recognize, as appropriate theory and analysis might have predicted, that they contributed mightily to bringing us out of the major recession of 1981-82. Further, contrary again to all the usual rhetoric, they have been accompanied not by an increase in inflation but by its virtually complete elimination. Curbs on our expansion and return to relatively full employment have come not from the budget deficits but from high real interest rates and the huge trade deficit.

Unless direct action is undertaken to reduce real interest rates and reduce our trade deficit, major reduction in our budget deficits will make our economic situation considerably worse.

Reducing the federal budget deficit to $108 billion in fiscal 1988 would mean an enormous reduction of $113 billion from the actual deficit in 1986. The critical "structural" deficit (measured at a generous 6 percent rate of unemployment) would be reduced proportionately even more, from $186.8 billion to $89.8 billion. As a percentage of GNP, the most relevant way to measure it, the structural deficit would have been reduced from 4.4 percent to 1.9 percent.

Economists can never be really sure of many predictions. But unless something intervenes to help, almost every econometric model and every serious forecaster would have to judge that such an enormous decrease in fiscal stimulus in an already sluggish economy is a dangerous gamble, whether or not it is politically fashionable, for Democrats and Republicans alike, to assert their dedication to reducing the deficit.

All this is not to say that the current deficit is not too large and should not be reduced. If, as polls indicate the majority of the American people have come to believe, our huge increases in defense spending of the last six years have brought us to the point where military spending is excessive, wasteful, and quite possibly jeopardizing our security more than enhancing it, the deficit could well be enormously reduced both by eliminating

Pentagon waste and by sweeping programatic changes. And there may well be other areas of huge increase in expenditures, such as in agriculture, where the excess spending, in failing to come to grips with essentials of our farm problems, only contributed to making matters worse.

But our overall budget posture must be app-oached with clear realization that we do not currently have too much overall stimulus. We rather have an improper mix of government policies, both within the budget and as between our fiscal and monetary regimes. The budget deficit can and should come down if we can be assured of a sufficiently aggressive monetary policy to drive down interest rates and the exchange value of the dollar, so that private investment and our exports can recover their rightful place in our economy. Until we can be assured of that, real, major reductions in the budget deficit, whether by expenditure reductions or by tax increases, threaten lower growth, more unemployment and less consumption and investment. The $108 billion Gramm-Rudman target came out of an arbitrary formula with no relevance to the real needs of the economy.

**3. Fixed Deficit Targets**

The difficulties with fixed deficit targets are that they ignore the state of the economy, including its rates of growth, unemployment and inflation and the framework of money and credit, and that they relate to a poorly defined and uncertainly relevant measure of the deficit. The actual deficit which Gramm-Rudman would have us target is greatly affected by the state of the economy. If economic growth slows, profits fall and unemployment rises, tax revenues decline and certain expenditures, such as for unemployment benefits, rise. The deficit thus grows. This is precisely the time when government should avoid curbing the economy and should rather encourage its recovery. Fixed deficit targets, under these conditions, however, cause the government to drag the economy down further, either by raising taxes or similarly reducing private income by reducing government outlays.

Similarly, in periods of inflation such as those brought on by the oil-price shocks in the 1970s, the budget deficit is swollen by high nominal interest payments on existing federal debt. These high interest payments are balanced by an unmeasured inflation tax imposed on holders of money and federal securities. This tax, as much as any other, reduces purchasing power and aggregate demand. Fixed targets such as in Gramm-Rudman would nevertheless force further fiscal restraint which would slow growth and raise unemployment all the more.

The fixed deficit targets, particularly within the framework of a federal budget which, unlike the accounts of private business and state and local governments, makes no distinction between current and capital expenditures, invite reductions in public investment as the short run means of meeting targets. Failing to meet our needs for roads, bridges, airports, preservation of natural resources and vital investment in education, training and research has devastating effects upon economic growth, productivity and the long run economic health of the Nation.

**4. The Goal of a "Balanced Budget" in 1991**

Surprising as this may seem to those overwhelmed by current rhetoric, there is nothing necessarily desirable about a balanced budget, at least one balanced by federal accounting procedures, in 1991 or any other time. In fact, very few major private businesses have "balanced budgets." Rather, they borrow and go further and further into debt each year, as may be noted from the accompanying table of the history of two of our largest and over the years most successful American companies, IBM and General Motors. And contrary to most mindless statements, private individuals frequently do not have a "balanced budget" and should not. If they always did balance their budgets most Americans would never be able to buy a house and many would be unable to buy automobiles or invest in the education of their children.

As I have already observed, actual budgets will normally fluctuate with economic activity, tending to deficit or greater deficit when the economy slows, and moving to lesser deficits or possibly surpluses in times of economic boom. Insisting upon a balanced budget regardless of these fluctuations is like commanding the tides to cease and ocean waves to stop.

But even over the long run, there is no clear virtue in maintaining a budget which is on average balanced. A more reasonable target might be to keep the debt, and costs of servicing the debt, in some fairly constant ratio of the Nation's income and product. In a growing economy we may well find a desirable equilibrium path in which income, debt, assets and net worth all grow in proportion. If our gross national product were growing at the very modest rate of 6 percent per year, which is less than that forecast by the Administration in each of the years from now through 1991, the debt could grow at 6 percent per year without the debt-GNP ratio rising.

With GNP for 1987 running at some $4,400 billion and the federal debt reaching a total of about half of that, or $2,200 billion, the implications are striking. An increase of 6 percent would raise gross national product to $4,664 billion. A corresponding increase of 6 percent in the debt would raise it to $2,332 billion, still no more than half of GNP. But the way that the debt goes from $2,200 billion to $2,332 billion is, simply enough, to have a deficit of $132 billion.

A deficit of $132 billion, then, equal to 3 percent of gross national product, will in fact keep the debt-GNP ratio constant. Looking ahead to 1991, when the gross national product will be close to $6,000 billion and the federal debt perhaps $3,000 billion, an "equilibrium" deficit would amount again, with GNP growing at 6 percent a year, to 3 percent of GNP, at this time $180 billion.

There is of course nothing sacred about any given ratio of public debt to gross national product. But if we are looking for a norm from which to judge departures we may well take that rather than the so-called balanced budget. For after all the sky has not fallen with our current debt-to-GNP ratio. Drastic changes in it can have serious implications for financial markets, aggregate demand and purchasing power, and the mix of public and private investment.

In any event, achieving an officially balanced budget in 1991 would entail such a huge increase in fiscal restraint as to make extremely difficult, if not impossible, the provision of a climate in which American business could prosper and we could achieve anywhere near full utilization of our Nation's human and physical resources.

**5. Spending Versus Taxes**

In terms of current aggregative effect, there is little difference between reducing the deficit by cutting spending or by raising taxes. Both reduce the increase in private sector holdings of government bonds. Both reduce purchasing power and total demand and spending. Reducing federal outlays for goods and services does have a direct and hence sharper effect on demand for output than cutting transfer payments or raising taxes. For each of the latter has its impact on purchases of goods and services only to the extent that individuals and businesses reduce consumption and investment spending in response to their reductions in after-tax income.

It must be asserted that there is a certain hypocrisy in refusing to raise taxes, which takes income away from some Americans, while favoring reduction of government programs, which similarly takes income away. What, after all, is the difference between reducing social security and unemployment benefits directly or reducing them by taxing them? Honesty must cause us to recognize that the differences between raising revenues and reducing spending frequently do relate to differences in incidence, that is, who actually pays. It is difficult to avoid the impression that insistence on cutting spending while refusing to roll back some of the huge tax cuts in recent years has more to do with the politics of appealing to voters who object to higher taxes while cutting benefits for many, frequently poor and powerless Americans without much political clout. Recognizing the politics of the situation, however, I would hardly advise the majority party in the Congress to "make the President's day" by taking any initiative to raise taxes. Putting our fiscal house in order by means of a package that includes higher taxes would certainly appear to require a bi-partisan approach, including both the White House and the Congress, rather than a search for partisan advantage on what has clearly been a potent political issue.

From an economic standpoint, to the extent deficit reduction is in order, it is cruel to do so by further reducing programs for the poor, sick and

elderly. And it is folly to reduce the deficit by cutting expenditures for education of our young, training and retraining of our workers, the health of our citizens or the public capital on which private progress depends. The Administration budget goes dismayingly further on that path of literally disinvesting in the United States. The short-changing of education in particular, and of public investment in general, have had a major impact in slowing economic growth. The longer we delay reversing this direction of public policy the greater and more long run will be our costs in the future.

**6. Selling Government Assets and "Privatization"**

Privatization, or turning over public functions to the private sector, is an issue that can well be argued. Some government activities might be better carried out by private firms motivated by the lure of private profits. One may also argue that there are other activities now in the private sector that might be better undertaken by government. But this has nothing properly to do with the issue of reducing government budget deficits.

Bluntly, proposals to reduce the deficit by selling government assets are deceptive trickery. They may be likened to those of a complusive gambler who tells his family not to worry about his continued losses because he is "financing" them by selling the family jewels, car, furniture and house. If the Administration wished to pursue this policy to its logical end, it might propose to sell our vast military arsenal to the firms and defense contractors from whom we purchased it, preferably at their cost-overrun prices, and then rent it back from them. For a number of years, perhaps at least until 1991, we will be able to say the budget is "balanced" by the excess of the receipts from the sale of planes, bombs and missiles over the rental payments. (Of course we would be selling all this to our own loyal weapons manufacturers and not to moderates in Iran.) What we would do for an encore when, say in 1991, we have sold off all of these weapons, is an interesting question.

To follow the absurdity further, we might sell the White House and the Capitol to private entrepreneurs who could turn a pretty profit by charging the President and the Congress rent for their use and perhaps adding some extra income by imposing "user fees" for tours of the President's living quarters or admission to the Capitol gallery.

On I trust a more realistic note, the ineffectiveness of asset sales in counteracting real effects of the deficit may be seen in the proposals in the Administration budget to sell loans from the portfolios of a variety of government agencies. The President's budget envisages a $4.2 billion reduction of the deficit from selling loans with a face value of $11.2 billion at a price of $5.3 billion. Net proceeds are estimated at $4.2 billion because even in this initial year of 1988 the government would be losing $1.1 billion in interest and normal loan repayments. These losses would accumulate in future years.

But the nonsense of loan asset sales as a way of mitigating effects of large deficits becomes crystal clear when we consider their impact on financial markets. The concern of many with large federal deficits is that they cause private saving to be diverted to the purchase of Treasury securities rather than investment in the additional plant and equipment that might make American industry more productive. But what then is the difference between having private saving diverted to buy Treasury securities and having it diverted to buy securities from federal agency loan portfolios? The answer is simple. There is no difference.

**7. Public Policies for Economic Growth and Competitiveness**

"International competitiveness" can be assured by Federal Reserve policies which bring the cost of the dollar to foreigners back to its levels of a decade ago, or lower, if necessary. Whatever the rate of growth or productivity, if the price is right we can sell enough abroad to eliminate our trade deficit.

The promotion of economic growth and productivity requires above all a set of public policies that provide for the full employment of all of our resources. A situation in which more than eight million Americans are counted as seeking work and having none, while millions more wanting full-time work are consigned to partial employment or are so d scouraged at the lack of job opportunities that they have ceased seeking employment, should be viewed as a

national calamity. It is imperative, to begin with, that we have fiscal and monetary policies that contribute to purchasing power or aggregate demand sufficient to buy all of the goods and services that can be produced if all those able and willing to work are working.

But beyond that, we must maximize the number of Americans able to work. We must see to it that all are educated and trained to be productive workers if they so choose.

And now a few "don'ts" regarding budget-busters in the false name of growth and competitiveness! The Congress should resist the appeals, frequently on the part of those acting in short-sighted selfish interest, to restore various of the "tax incentives," better described as tax expenditures or tax loopholes, which it did much to eliminate last year. I have in mind particularly the investment tax credit, costing over $20 billion per year in tax revenues, and the Research and Experimentation (R and E) tax credit, which was reduced from 25 percent to 20 percent and extended another three years. I have been substantially involved in the study of both.

The investment tax credit, by sober calculations, did little to stimulate investment but, what was worse, could only have increased that marginal investment which was not sufficiently profitable — read productive — to be undertaken without the benefit of special tax advantage. The R and E (or R and D) tax credit, on which I shall focus briefly because of current proposals to raise it back to 25 percent and make it "permanent," was — and is — a turkey. It had the worthy objective of promoting research which, because its public benefits may considerably exceed the private gains it may produce, private industry is unlikely to undertake sufficiently on its own. It was unfortunately an ill-conceived tool.

The credit which expired in 1986 did hardly anything — and the current law is little better — for the basic research which needs support. Rather it resulted in losses in tax revenues of up to $1.5 billion per year for the benefit almost exclusively of applied research and of "development," for which the lure of private profit should be sufficient incentive without added Treasury largess.

And, all the worse, as formulated, the R and D tax credit is in considerable part perverse. Because its tax savings relate to increases in expenditures over a company-specific base, the rational firm must recognize that increasing R and D spending now will raise its base and thus raise future taxes. In a substantial study for the National Science Foundation (reported on in the National Tax Journal, June 1984, in Hearings of this Committee's Oversight Subcommittee, August 1, 1984, and elsewhere), I found that this factor, combined with other peculiarities of the law, could have caused many firms actually to reduce their R and D spending and contributed to the credit's general ineffectiveness.

Investment or capital accumulation is widely viewed by economists as the key to growth. What is frequently forgotten is that private, largely business investment is only a small portion of the total investment in the economy. The great bulk of this, some 80 percent by my calculations, is in the form of public capital, developed land and natural resources, harbors, roads, bridges and airports and, most important, our human capital. Public policies directed to all of this public investment, to basic research and to developing the strength, skills and ability of our people are the path to economic growth. Arbitrary deficit targets, distortionary tax concessions and curbs on needed public expenditures place mighty obstacles in that path.

From Robert Eisner, How Real Is the Federal Deficit?, New York, The Free Press, 1986

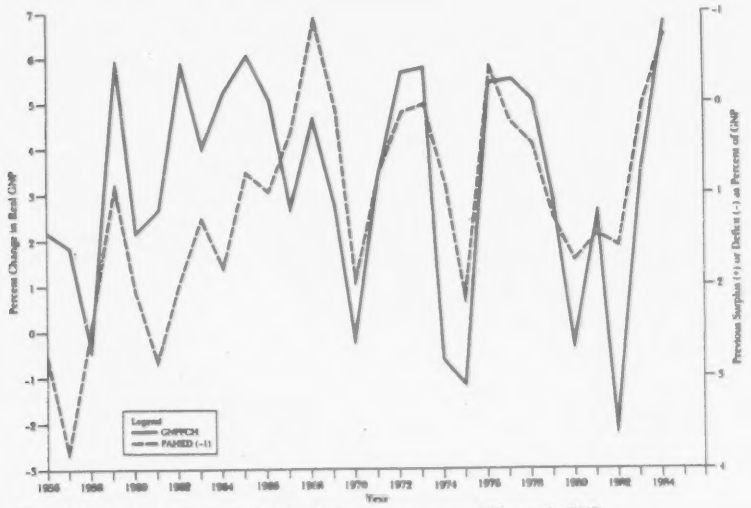


**Figure 8.2** Lagged Price-Adjusted High-Employment Deficit and Change in GNP

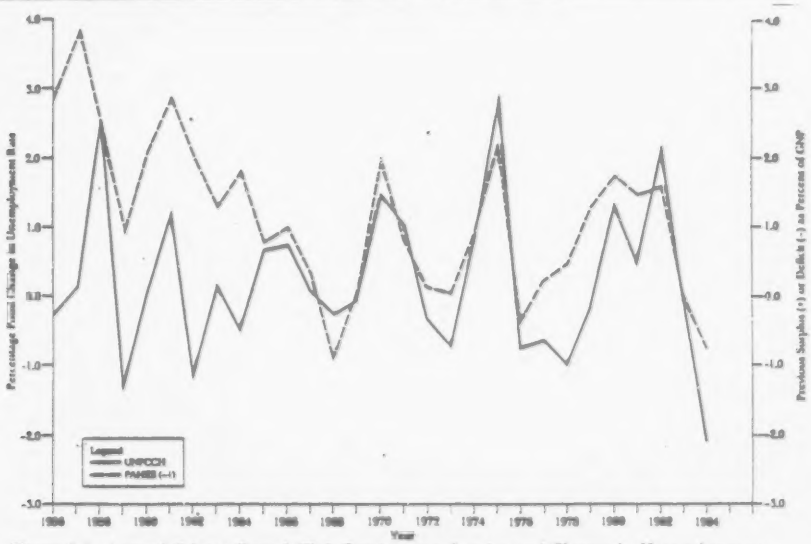


**Figure 8.3** Lagged Price-Adjusted High-Employment Surplus and Change in Unemployment

TABLE 3.1 Assets, Liabilities, and Net Worth, General Motors and IBM, 1970, 1980, and 1984

| ITEM | YEARS | | | |
|---|---|---|---|---|
| | *1970* | *1980* | *1984* | *1970 to 1984* |
| | ($ BILLION) | | | (% CHANGE) |
| *General Motors* | | | | |
| Assets | 14.5 | 32.2 | 52.1 | +258 |
| Liabilities | 4.5 | 13.0 | 27.9 | +546 |
| Net worth | 9.9 | 19.2 | 24.2 | +146 |
| *IBM* | | | | |
| Assets | 8.5 | 24.5 | 42.8 | +401 |
| Liabilities | 2.6 | 9.6 | 16.5 | +530 |
| Net worth | 5.9 | 15.0 | 26.5 | +345 |

Source: Data for 1984 are from annual reports. "Net worth" figures are what GM denotes as "net assets" and IBM as "stockholders' equity." IBM figures for 1980 have now been reclassified to conform with the 1984 presentation. They show 1980 assets at $26.6 billion and stockholders' equity at $18.6 billion.

[Mr. Eisner also submitted the following articles which are being retained in the committee files: "The R&D Tax Credit: A Flawed Tool" from Issues in Science and Technology; "The New Incremental Tax Credit for R&D: Incentive or Disincentive?" from the National Tax Journal; and review by James K. Galbraith former Chief of Staff of the Joint Economic Committee, from Challenge, of "How Real Is the Federal Deficit?" by Robert Eisner.]

Chairman ROSTENKOWSKI. Thank you, Dr. Eisner.

We are all aware that the Gramm-Rudman target for fiscal year 1988 is $108 billion. I would like an opinion from you gentlemen, as to whether or not that is a desirable economic target. I view it as political, and I am sure that most people do. However, I would like to know whether or not that is a desirable target, and recognizing that social security and benefits such as that are off limits—something that I don't really agree with, but they are off limits—I would like to get an idea where you feel we could raise the revenues other than the specifics that Dr. Sinai has mentioned.

Dr. Greenspan, would you like to begin with that?

Mr. GREENSPAN. It is obviously a highly unrealistic target. There is no way that the Congress can get there. First, I think that the current services budget deficit is significantly underestimated. You may wind up with a situation in which you will be fighting a deficit which is closer to $180 than $108. When you are dealing with that sort of situation, I think it is realistic to position the Gramm-Rudman targets much higher than they currently are.

But I recognize that you are not trying not to get the deficit down to the Gramm-Rudman targets, because all that is required by law is that that is the goal in the initial estimates. Nonetheless, I think that the estimates should be raised, but I do not believe that the process should be abandoned. As difficult as it is, and as technically questionable as the whole notion is, I do think it would be helpful. I would hate to see the Congress abandon it. The technical upward adjustments can be anywhere from $20 to $40 billion. I am not sure it matters. I grant you it should be raised, so we don't have too much of a gap between the target and reality.

Chairman ROSTENKOWSKI. Dr. Schultze.

Mr. SCHULTZE. First, I think to try to pull the budget deficit down in 1988 by $60 or $70 billion, as would be required to meet Gramm-Rudman, is too much for two reasons:

First, it is too much for the economy in 1 year. I don't think the Federal Reserve would have the capability of offsetting it with easier money, to offset the impact of that on the economy.

Second, I think it is bad because in fact you are not going to do it and this will be a tremendous temptation to do it with smoke and mirrors, which discredits the whole process.

On those two grounds, I would say you shouldn't do it. That doesn't mean you should do nothing; I think the deficit ought to come down for the next 2 or 3 years by $30 to $40 billion a year, not $60 to 70.

Then you ask what revenues should be raised, on grounds that you can't lower the deficit sharply otherwise I think the following comments on revenues:

No. 1, I think you need to look not at 1988 alone, but target out to 1990 and phase in a revenue increase. The kind of revenues you are ultimately going to need might be too much for 1988 but it would help the economy, it would help financial markets if you had in place a downward path of deficit, let's say through 1990, with a phased-in revenue increase. Don't look at 1988, look at 1990. There you are going to need $50 billion in additional revenue.

Second comment on revenue, if I had my druthers, which I won't, I would be adding 2 percentage points to the rates. I think that rates in the individual and corporate tax, I think we missed a great bet by making last year's tax reform revenue neutral. Since you are going to reduce people's marginal rates anyway, to have reduced them less than you did would have been the ideal way. I would add 2 percentage points back to personal and corporate tax rates.

If that is not possible, then I would look toward some combination of an energy tax—not an oil import fee. Every $3 that consumers pay under oil import fees the Government gets one and the oil companies get two. I wouldn't go for an import fee, but a broad energy tax, yes.

Chairman ROSTENKOWSKI. Gas?

Mr. SCHULTZE. I am not sure I would do it only on gasoline. It would be heavier on gasoline. The main problem with energy taxes is that you have to be careful not to penalize American producers of energy intensive goods and in this particular situation, exporters of energy intensive products. Excise taxes, take another look at them and also I would look very carefully and sympathetically at the administration's list of user charges, which I realize the Congress has been presented many, many times in the past, and has refused to go along, but I still think some make sense.

One thing I would caution you—although I don't think it is a great danger—do not toy with the value added tax, for two reasons. One reason, if you are going to do value added tax, do it big. It does not makes sense to set up a major new administrative apparatus to pick up $30 or $40 billion.

Second, on the value added tax—this may come strangely from somebody who served in Democratic administrations—but the problem with the value added tax is it is too easy, once you get it in. Do you do believe European governments could have gotten their government expenditures up to 50 or 55 percent of GNP without a value added tax?

So you need revenues, you ought to raise them. I would like to add 2 percentage points back to income tax rates. If you can't do that, I like the energy and excise tax package. I wouldn't go for the value added tax.

Mr. SINAI. Depending on whose current services baseline is used, the cut job is $70 to $100 billion in fiscal year 1988. That is large, it would take too much out of an economy that is just getting a little head of steam back. So I think you have to change that Gramm-Rudman-Hollings target. But you ought to have that or something like it as a kind of spiritual discipline. The fact is that it was not followed to the letter last year, but it is a directional signal for Congress, the country, the administration, together, and we all believe the deficit should go down.

I think OMB and CBO could calculate structural budget deficits. Take an average of those two calculations and some others and then subtract the Gramm-Rudman target. That would give the necessary cut job and then you can adjust the Gramm-Rudman target that way. You would get a more realistic, and doable, and reasonable cut job for that type of calculation, through structural budget deficit estimates.

The mix of how the deficits are reduced, how much it would be—and it would be considerably less than $100 billion, and include the revenue side.

I think we would all hone in on excise taxes—alcohol, et cetera, as a possibility. But can't raise a lot of revenue in this way.

Energy taxes make some sense, although they can be regressive in certain ways. I think I suggested that.

User charges, as a means to raise receipts for the Federal Government, I thought this suggestion made good sense in the budget and that some of the privatization measures were sensible.

But you don't get a lot of revenues out of anything other than measures like a value added tax, or raising income tax rates. I think none of those would be wise, and I share with Dr. Schultze the negative view on value added taxes.

I don't think you really have to go to that kind of big change in the tax system to get the deficits down. If the burden is shared between raising revenues, cutting on defense, cutting defense and also by the Federal Reserve, good progress can be made. Here is where we run into a problem in our system. We just cannot coordinate fiscal and monetary policy well enough.

The fact is, if Congress really were going to make bona fide cuts of $40 to $50 billion, in this kind of atmosphere where it is so important, the Federal Reserve ought to be able to, should guarantee a compensating ease in monetary policy. You ought to be able to get some handle on interest rate effects and that would give you a bonus. Plus, the growth you would get back from the Federal Reserve will save, get you some returns that you lose from the budget restraints.

Mr. DORGAN. You accepted Mr. Schultze's assertion that two out of three dollars of an import fee goes to the oil companies?

Mr. SINAI. No.

Mr. DORGAN. I don't necessarily accept or understand that statement. I wonder if we could clarify that at this point?

Mr. SINAI. I don't know. But if what he said is correct, I would probably vote for broad based excise taxes and general energy taxes——

Mr. DORGAN. It occurs to me if we impose an import fee, that the proceeds of the fee go to the Federal Government, you are suggesting somehow $2 goes to the oil industry?

Mr. SCHULTZE. You raise the import fee, let's say $5 a barrel. That means all domestic prices are going to go up $5 a barrel.

Mr. DORGAN. The point is the fee that is collected goes to the Federal Government in its entirety.

Mr. SCHULTZE. Of every dollar that consumers pay, the Federal Government gets 33 cents. I am not suggesting the import fee does not go to it. What you are doing is taking money out of consumers' pockets and giving it in effect—let's say it is not two thirds, maybe

it is 60 percent—because you will get some back in higher corporate profit taxes, but something like 60 to 66 percent out of the consumer dollar will go to the oil companies, and somewhere between 30 and 40 percent will go to the Federal Government, and I don't think that is good under the current circumstances. At least I don't think that is a good buy.

Mr. DORGAN. Just to clarify, I understand your point now, but the proceeds of the fee itself will go to the Federal Government in its entirety?

Mr. SCHULTZE. Yes sir.

Mr. EISNER. I do agree with much of what the others have said. The Gramm-Rudman $108 target is like all Gramm-Rudman numbers, picked out of a hat. It has nothing to do with the needs of the economy now. To try to hit $108 billion would threaten disaster. I think the Congress will not do it. If it did do it, it would be bad.

But then the question is, what to do, and here I think it may be a pie in the sky, but you have to have some kind of agreement with the White House, and with the Federal Reserve. I would not recommend to the majority party that it take any measures to raise taxes and make the President's day. You have got to get him to agree and go to the people with you and say look, to the extent we have to reduce the deficit, then it should be a sensible mix, and having increased the military tremendously, and cut taxes, the rather obvious way to proceed is to undo some of what was done while he said he was going to balance the budget. It was just bad arithmetic, as anybody with any sense knew.

You also then have to really have an understanding with the Federal Reserve about legislation one way or another, because, as has been suggested, most forcefully again by Dr. Sinai—I would like to emphasize it—can you divorce this? If you are concerned with the fate of the economy, you can't pick any number and say we are going to have this deficit regardless of what the Federal Reserve does. There is some point, as has been suggested, where there is no possible Federal Reserve policy that would be sufficient. But you have to say, what will be the impact on the economy?

I must differ with Dr. Greenspan, who had to leave. You cannot have any assurances that reducing the deficit is going to result in the economy improving because financial markets will take off. That is really a pie in the sky. I don't believe Dr. Sinai's model or any other model will show that.

Reducing the deficit in itself is a drag on the economy. I am not saying the deficit shouldn't be reduced; there may be much wasteful spending. But don't kid yourselves that is going to stimulate the economy. You don't stimulate the economy by decreasing deficits. To the extent you do reduce the deficit, you have to have an easier monetary policy, or you risk dragging the economy down.

Chairman ROSTENKOWSKI. Mr. Stark.

Mr. STARK. Pass.

Chairman ROSTENKOWSKI. Mr. Duncan.

Mr. DUNCAN. Thank you, Mr. Chairman.

I want to thank the panel also.

Dr. Eisner, your definition of a balanced budget is a little different in my household than it would be in the Federal Government. I think the average American, when he talks about a balanced

budget in his home means that he has enough money coming in to pay his obligations. However, if he followed the example of the Federal Government, he would not have enough. There is a great deal of difference in an individual's balanced budget compared to budget policy as followed by the Federal Government, would you not agree?

Mr. EISNER. Well, there is not as much difference as one makes out, because the individual can meet his obligations by borrowing. If he buys a house, he borrows and pays for the house that way.

Mr. DUNCAN. That is included in the payments. If he continued to borrow, at the end of the year, he will go deeper into debt.

Mr. EISNER. That is correct. There is a distinction.

Mr. DUNCAN. He has a problem. That is what we have now.

Mr. EISNER. Not entirely because the Federal Government does not account that way. The Federal Government includes in current expenditures all of its capital spending. If you were to have a separate capital budget as I and some other economists have recommended, you would then be able to see clearly how much you are living beyond our means currently and how much you are borrowing in order to invest in the future. That doesn't mean that spending of any kind doesn't impact on the economy, but you would in that sense know the extent to which you might be improvident in terms of putting a burden on the future.

Now, we are probably running currently a current deficit as well. I don't mean to say that all the deficit will be wiped out by that but your Federal accounting is misleading in this regard and it is——

Mr. DUNCAN. You advocate high deficits and an easier monetary system at the same time?

Mr. EISNER. Well, I would say not necessarily high deficits but you have to see to it that the economy is prosperous and you have to recognize that deficits stimulate, and that money can stimulate. You have to have a mix that will give you enough stimulus. I probably agree with all of my colleagues that the current mix is dumb. I mean, we should have easier monetary policy, and to the extent that we can, a tighter fiscal policy. But a fiscal policy like Gramm-Rudman targets would be much too tight and a balanced budget now and in the foreseeable future would be much too tight.

Mr. DUNCAN. I am not really optimistic we are going to have a balanced budget anyway, because when the Speaker was here yesterday, he stated that he wants more money for this and more money for that, and the administration wants more money for defense, so I am not optimistic. We appear to be back on the same cycle we have been on for a long time. How does our debt compare in relation to the gross national product with other countries, other industrial nations?

Mr. SCHULTZE. I don't know. I don't have those numbers. The one thing I can say, it is higher than Japan and lower than most European countries, perhaps with the exception of France. But beyond that, I can't tell you.

Mr. SINAI. I don't have the figure here. I would be sure that the perception is that ours is relatively high. If you add up all the dimensions of the debt, the consumer debt, business debt, we are be-

coming a debtor government, the government debt, we are a high debt nation.

Mr. DUNCAN. It is my understanding that a year ago the U.S. debt in relation to GNP was lower than that of our trading partners around the world. I don't know what it is today.

You mentioned an import fee. Have you given any thought as to what might happen to the petrochemical industry? For example, only 45 percent of a barrel of oil is used for motor fuel and the petrochemical industry says that they already have a tough time competing with imports. But if you add further cost increases, it would devastate that industry. Do you have any thoughts of what might happen to related industries?

Mr. SCHULTZE. Well, I can't—let me use that to maintain a point about energy taxes. I can't answer your question about what it would do except generally. One of the reasons why I would strongly prefer just adding 2 percentage points to the existing tax rates, which has no impact on incentives, is that there isn't any way to raise taxes—which I think we are going to have to do—without having some distorting effects on the economy. Anything you do—and energy taxes which has some merits, is going to do that—precisely with respect to discouraging American production and exports of energy intensive goods.

All the chemical companies will be particularly hurt and I don't think that is good. Therefore, if you are going to have an energy tax, I would make it relatively low on everything but gasoline and high on gasoline. But I come back to my original point that difficult as it is, with any tax, I think when you really look at it probably the least distorting within limits of practical possibility is just taking the system we have and raising it a little bit.

Mr. DUNCAN. My time is up. Do you favor an additional tax, is that right?

Mr. SCHULTZE. Yes sir.

Mr. DUNCAN. And Mr. Sinai?

Mr. SINAI. Yes sir, I would favor modestly higher taxes.

Mr. DUNCAN. Not at this time?

Mr. SINAI. Not increasing corporate or income, personal income taxes. I think you don't need all the revenue. If this were done properly, you don't need all the revenue that would raise, and once it gets into the system, I don't think we would be that happy with the results. It is inflationary and can be regressive.

Mr. DUNCAN. Dr. Eisner, do you favor higher taxes?

Mr. EISNER. Higher taxes in general?

Mr. DUNCAN. Yes sir.

Mr. EISNER. I think that is a political judgment and stating that I would state my judgment, my preference would be, to the extent that you are going to cut the deficit, to cut military spending. I think that is exorbitant, but aside from that, I think economically it doesn't matter that much, in the overall, whether you raise taxes or cut spending.

Mr. DUNCAN. Thank you.

Chairman ROSTENKOWSKI. Mr. Stark.

Mr. STARK. Thank you, Mr. Chairman.

Dr. Eisner, you were, in your statement about debt, making some statements I agree with. I am also hearing signals out of the White

House that maybe we ought to go to a capital budget, which in effect would probably overnight give us a surplus. I suppose, if we spread all the capital expenditures out over the average length of Treasury bonds, we might find that we are then keeping books the way everyone else does, as they say.

If you could find a way to switch our accounting, our Federal accounting, so we had capital without doing a mirror and smoke hiding of the deficit, is it a good idea. Is there something we would benefit out of getting our thinking, our budget, and our legislative process, on to a capital budget where if we buy a nuclear aircraft carrier or star wars system, we say it is a long term debt of, say, 12 years. Therefore we take it into account over that period of time, or is that just begging the issue?

Mr. EISNER. I think it is best to get the information out honestly. I have somewhat mixed feelings. One reviewer of my book indicated that all conservatives should read it, it shows you can go ahead with star wars and big defense expenditure and not worry. That of course is not my argument, but I think we have to be honest and distinguish between capital spending and current spending.

My estimates, for good or bad, do not show that you are going to eliminate the deficit on current account by separating out a capital budget. You have to remember that while you have about $200 billion of capital spending, which you take out, correct accounting would then have to put back some estimate of depreciation on this. So you probably knock out a third of the current deficit, maybe a little bit more, but the main change I see is it might discourage some of the phony accounting.

Mr. STARK. Do States do depreciation?

Mr. EISNER. They probably don't. Private companies do.

Mr. STARK. I don't think the States do.

Mr. EISNER. You are quite right.

Mr. STARK. That is why I think that is what——

Mr. EISNER. I would say that would be misleading too. With correct accounting you should have an estimate of depreciation.

Mr. STARK. Thank you.

There was some feeling if we had done what modestly is referred to as the Stark-Chaffee proposals, which is to cut the deductions and tax incentives and tax expenditures rather than raise rates, that somehow the White House wouldn't consider that a tax increase. If that is what they think, that is okay with me. Is there anything in that procedure, as a revenue raising gimmick that is? I think it just tends to tax those who pay the least taxes a little more rather than the reverse, as a surtax does.

Would you have strong feelings if we said look, for 3 years we are going to reduce all deductions by 10 percent or 5 percent, and to me it is fairly straightforward revenue raising, but are there any downsides in that from an economist's point of view?

Mr. SINAI. I don't think so. I think you are right about the lesser incidence. Did you say for 3 years?

Mr. STARK. Two years, 3 years, whatever we need in terms of revenue. I think politically it is more palatable if you say we are going to do it for a little while. We are then keeping faith with the people who supported us in our tax reform of the last year and you

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are not raising rates, you are postponing—rather than postpone the rate cut, you postpone some of the deductions.

Mr. SINAI. What happens to the problem 4 or 5 years down the road? I have no problem with that as a nontax way of raising revenues. I would suspect you can't get a lot of revenues that way.

Mr. STARK. You can actually get a good bit, but I don't know what it would be after the tax reform bill. A lot less, because there are a lot fewer loopholes to close.

I would love to go on about military spending versus other kinds of spending, what it would do to the economy, but I want to ask the panel's opinion here. It just seems to me that if we are staying the present direction, and within the present band of the deficit, and the mix of federal spending, and the tax system, that we are going to get forced into increasing interest rates, just to refund the debt. Interest rates in my simple pedestrian approach, have got to go up.

There is an alternative. That is inflation, which is politically so nice because everyone feels good, the cocktail party circuit can talk about the increase in the value of their condo and senior citizens Social Security is indexed to a COLA. Nobody gets hurt right today with inflation and it is a quick way to monetize the debt. Do you all think we are headed inexorably toward higher interest sometime in the next couple of years? Is that almost a given? That is what I would ask the panel in general.

Mr. SCHULTZE. I would now say this with a confidence maybe of 75 percent, not 100, but in a world in which the trade deficit does what I think it is going to do, which is to shrink pretty close to zero, and budget deficit remains high, I think you can describe it any number of ways. You are going to have too much demand and overheating in the economy and/or you are going to have an insufficiency of savings to finance the deficit.

I think the probabilities are quite high that you will get an increase in interest rates and a reduction in domestic housing and investment magnitude I don't know, but basically it is not going to be good for long term growth of the economy. It won't be disastrous but it won't be good.

Mr. SINAI. It is inevitable, if you don't deal with the Federal budget deficit problems, it is just a question of when, and I think it would be sooner than my colleagues might think, and maybe even surprisingly punitive, because financial markets have a habit of not waiting any more. And indeed, it may be that that rise in interest rates has already begun.

Mr. STARK. We have built in the variable rate, which suddenly gives a much quicker feedback we didn't have before. Thus institutions just raise rates to attract savings because their assets follow so nicely.

Mr. SINAI. The same business cycle danger exists through different mechanisms, this time accelerating inflation, higher interest rates, the usual financial troubles, that interact with other problems in the economy to put you into a recession. What is sobering from the point of view of budget policy and taxes is that the next time around, if you have a recession you will be replaying the same problems you have gone through the last 3 or 4 years, except the numbers will be higher.

Mr. EISNER. This time I have to disagree sharply with my colleagues. We have had bigger and bigger budget deficits and we have had falling interest rates since 1981. They have gone way down. Interest rates are going to reflect expected inflation. They are going to reflect Federal Reserve policy. They are going to reflect interest rates in the rest of the world.

Now, I would agree with Dr. Schultze that I can't attach any high degree of confidence to any prediction he or I can make. There is no clear indication that interest rates have to go up or even that they will go up. Again, that will depend critically on Federal Reserve policy.

Mr. STARK. Does the value of the dollar——

Mr. EISNER. Driving down value of the dollar is already having beneficial effects in forcing foreign countries—Germany in particular—to begin to cut interest rates, cut their discount rates.

The driving down of the value of the dollar stimulates the economy. We really get not a recession, but a boom. Interest rates may go up, but if the boom is brought about by easier money, which lowers interest rates, then you have a contradiction in terms.

I think there has been a lot of confusion introduced, if I may say so, by our monetarist colleagues over the years, who tell you increasing quantities of money will not lower interest rates, it will raise them. They have a point which is much misused. If raising the quantity of money will cause inflation, that will raise expected inflation and raise nominal interest rates, even though it might reduce what is most relevant, the real interest rates.

However, you cannot generally say that increasing the quantity of money any more than deficits, will cause inflation. Again, we can go through sophisticated analyses but I just appeal to recent facts. Moneterists have been crying bitterly about what is happening to M-1 and M-2. M-1 is rising out of sight. What happened to interest rates? I am not talking day-to-day fluctuations; they have gone down and down.

So that we have to avoid this simplistic notion that interest rates have to go up or that the Federal Reserve cannot drive them down. They can, and they should be pushed to do so.

Chairman ROSTENKOWSKI. Mr. Flippo.

Mr. FLIPPO. Thank you, Mr. Chairman.

Dr. Sinai, you have stated that you think it is already too late to move abruptly to achieve the Gramm-Rudman targets without disrupting the economy, and you also mentioned certain cyclical adjustments that should be made. Have you run any figures. Can you tell us what the Gramm-Rudman target should be if it were adjusted as you suggest?

Mr. SINAI. No, we haven't done that. We could do that. As I said, the rough rule of thumb would be to try to move the cyclically adjusted or structural budget deficit toward zero over a string of years. We did calculate what those cyclically adjusted budget deficits would be if you are given the numbers now and go ahead and meet Gramm-Rudman targets. It turns out there would be a surplus in about 3 years. So I think very roughly—this is without having done it—we can do that. I think you probably subtract from the cut job $30 to $40 billion a year.

Mr. FLIPPO. After making the adjustments you suggested you would be talking about $30 billion or less than that?

Mr. SINAI. Yes sir, although this is a rough estimate off the top of my head. As I said, if that were done by a mix of measures—you see, if it is all on spending—if you do it by a mix of measures then no one area has to do a lot. And if at the same time one could calculate how much would come back in receipts through a compensating easier money policy by the Fed, to restore the growth lost by the budget tightening and gain from lower interest rates, I think sharing the burden in this way would not seem as though it was as massive as it now looks to everyone who studies the problem.

Mr. FLIPPO. In other words, you feel generally that a $30 to $40 billion correction—I am just picking these numbers out of the hat—would not be so disruptive to the economy, whereas $60 or $70 billion would be unduly disruptive?

Mr. SINAI. At this time, yes.

Mr. FLIPPO. The other thing I think that each of you may have made point that it is very difficult to deal with this total problem by fiscal policy alone. What we need is greater coordination—whatever that means—between fiscal and monetary policy. Apparently you do not feel that our present structure of government permits adequate coordination of fiscal and monetary policy. Would you or any of the other members of the panel have any suggestions as to how we might improve that coordination? Do we need to make structural or legislative changes? Or is the structure okay and all we need to do is find some way to pull it all together?

Mr. SCHULTZE. I have no major suggestion for improving the structure, because I don't think it is quite as bad as everybody else thinks it is. It is not perfect. I have no problems with part of it, but my main point is I am confident on the basis of the record of the past 3 to 4 years that if the Congress made a credible reduction in the budget deficit, the Federal Reserve would accommodate with easier money. Maybe they would be more cautious than I would be, but nevertheless, I think there is all kinds of evidence that that would roughly be the case, and off hand, I can't think of any structural change that wouldn't pose more dangers than it is worth.

Mr. FLIPPO. I guess my point is the frustration that we experience in discussing this subject with constituents or economists. Whether we are talking about fiscal policy or getting our fiscal deficits down, the so-called experts tell us that is not the whole problem, you can't do that without fiscal adjustments. In attempting to deal with trade policy, they tell us the same thing. No matter what the exchange rate, no matter how competitive you are, or there are other factors that are going to ultimately determine where you are coming from.

So everything we talk about trying to do here, whether it is fiscal or trade, or whatever, is dependent upon something that seems to be outside of our control.

Mr. SCHULTZE. I don't think so. If I may respectfully disagree, it seems to me the central economic problem—not the only problem, but the central problem with the United States, including its major grade deficit—fundamentally stems from the mistake that was made in 1981, we both cut taxes and raised defense spending substantially, and then borrowed like mad in a world in which capital

moves freely. We borrowed from abroad and the process drove up the dollar.

Sure the Fed has a lot to do with everything, but I see nothing in the recent record that wouldn't suggest that if the fiscal house could be got in order, that the Federal Reserve wouldn't, approximately at least, do what is necessary to keep the economy on an even keel while that is going on, including easing monetary conditions.

If it didn't, then I think it would be time to jump. But I do not think the record over the last 3 or 4 years suggests that the Fed would be unwilling to do so. Again, I think they might move more cautiously than a lot of us would like, but I think we are dealing with only marginal differences.

I fundamentally think it is the fiscal policy that the Congress and President can control, and I do not think the Fed would be a major problem in terms of being too cautious. It might be a little too cautious but not terribly so.

Mr. SINAI. I guess I am saying that I think we are beyond the point where we can go at this in a "who goes first' fashion. It is just too big a problem. It wasn't 2 or 3 years ago. I think if the deficits had not gone up so high then, it was possible. But the process of dealing with the budget last year took 8 months. That is no fault of Congress. It is a very difficult problem and involves negotiations with the administration, so you have an 8-month process. Then, if indeed you deliver the kind of cuts that the Federal Reserve would like, the Federal Reserve will think about when and how much they should ease, and then a third leg in the triangle, which is the international situation, and the open economy with the dollar that has a big effect on the Fed. So you do sequentially cut the deficit.

What does the Fed do? I think really I mentioned the grand scheme. It is a grand scheme because it is beyond the political process, but you have to set your sights on a coordinated approach to what is an incredible problem, and though it is not as bad as it was 3 or 4 years ago, if cuts were made, it is going to come back and do our economy in unless in the next year or so——

Mr. FLIPPO. Let me say I sincerely appreciate the testimony of our witnesses and I guess the more we examine this, the more sympathy I have for the committee that looked at the elephant from various points of view.

Thank you.

Chairman ROSTENKOWSKI. Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

I am almost sorry we don't have Paul Craig Roberts or somebody else here who could differ with our esteemed panel that is making eminent sense today. It has been in the past the prerogative of the chair to call disparate witnesses. There has been, in my opinion, far too much agreement, and I hear R&D tax credit. I think that might provoke some controversy.

I want to make first an observation, and then ask some questions. The first observation is, as much as I abhor Gramm-Rudman and did not vote for it, I can happily go home and explain it is moronic, the fact is I really believe that it has forced us to cut the deficit beyond a level which we would have cut it, and so Dr.

Eisner, I have great respect for your work and I agree with you fundamentally in just about everything you have said.

Without Gramm-Rudman we would not be dealing with lower deficits and we would be spending more on defense, so painfully as that is for someone who opposed Gramm-Rudman to admit, I want you to know it and appreciate it, and when you learn anything from us these days, that is one thing that is an inescapable reality.

The other concern I have—we had Secretary Baker here yesterday, and I pleaded with him to talk to the President on these matters and my view, there is a very tenuous grip on reality about whether or not the economy can recover ultimately, without some increase in revenue.

Secretary Baker said to me, that well, we historically are raising about 19 percent of GNP, but we are spending 24 or 24½ percent, and it seems to me inevitable that if this trend continues, that not only being a net debtor nation that we are, but that national future, in an attempt to pay back the debt, part of this debt, that inevitably means lower living standards for our people.

I would just like the three of you to wax on this point for a minute—the notion that no matter what we do, in the next few years, unless we see some dramatic productive growth, that the living standards of Americans are likely to decrease somewhat. All that we are really choosing between is whether they decrease precipitously or later on, do it gradually over the next couple of years. Even if we raise taxes in a way that is assumed by the administration, but frankly I believe we need to do that, living standards will go down.

Mr. SCHULTZE. One modification. I agree with you but the modification is that, to be honest, it probably won't lower living standards, it will just reduce the already low growth of living standards.

To give you some idea of the magnitude, since about 1983, we have liquidated $250 billion net acquisition abroad and we are now going into debt to the tune abroad of $140 billion a year, so that if you consider the lost earnings that we were getting, from the $250 billion, plus the debt service, we are going to have to pay, even if we never pay it, just paying the debt service, you are dealing with a swing of by 1990, of probably something in the neighborhood of $500 billion on which we will pay debt service.

Let's just for the heck of it say we have to pay 4 percent real interest rates. That is not such a magnitude that it is going to turn living standards down, but it will slow their growth. So I agree with you, except for that modification.

Mr. DOWNEY. And if I can have the other two members of the panel just address that briefly. One of the things that I have advocated around here, somewhat alone, is the idea of a higher inheritance tax as well as a possible way of raising money. It is not going to raise much, but it seems to me the least we can do to raise money without affecting aggregate demand and other things. I would appreciate it if you would comment briefly about that as a valuable method of raising revenue.

Mr. SINAI. Well, on the standard of living question, I guess I am sad to say in terms of growth of real income per capita, over the next 2 or 3 years current prospects, yes standard of living will rise less. One family member may work two jobs, now a second family

member may work one—three jobs for two people. More Americans will work for foreigners. That may be good, that may be bad. Americans may not feel comfortable with that. Those are just a couple of the trends we are on.

So I think the answer is yes, it is a more globally competitive world. We view our country's future arena in a way that is going to make it tougher for us. So the answer is yes, I generally agree with that perception.

On the inheritance tax, I should probably not make a comment.

Mr. DOWNEY. It seems to me that an argument——

Mr. SINAI. I am not even aware of the nitty-gritty.

Mr. DOWNEY. It disappears.

Mr. SINAI. I think I have a general feeling that the tax system certainly should be fair and one of the nice features of the new tax system is that it is more equitable, and so we may have gone too far in exempting from taxation the passing of funds which now can go to a spouse through a trust virtually tax free.

Mr. DOWNEY. Well, I would be happy, I am sure the staff would supply the percentages of the amount of money that has just disappeared as a source of revenue.

Mr. EISNER. I would say our standard of living is going to depend critically on what we do to raise our own productivity and that relates again largely to public investment, to education, to training. I must say, I have loved Charlie Schultze for many years. I would agree actually with the concluding numbers he gave, which I think should have deprived the argument of enough substantial weight.

To say that the budget deficit is driving down our standard of living, because it is increasing our debt to the rest of the world, or reducing our net investment position, I think is a tremendous stretch of numbers. Charlie pointed out that even if we run this trade deficit for 3 or 4 years, you run it up by $500 billion, he took a real rate of interest of 4 percent—4 percent is $20 billion a year, $20 billion out of the GNP of that time which will be around $5,000 billion more—I mean, Charlie, you are talking less than a half of 1 percent.

What is more, I have heard a lot of people saying——

Mr. SCHULTZE. Forever.

Mr. EISNER. You raise productivity, you raise your productivity by a substantial amount. You qualify that.

What is more, all of these figures on debt, foreign debt, are very misleading. I don't know how many on this committee have stopped to think while everybody says over and over again, we have become a debtor nation, we are still earning more on our investments abroad than we are paying to foreigners on their investments here.

That is an interesting number to wonder about and wonder, therefore, whether there is something wrong with the figures telling us we are debtor nation. I suspect there is a good bit wrong with them. They should adjust to the actual value of our investments abroad, compared to the investments of foreigners here. And you know, that changes tremendously. The depreciation of the dollar in the last year has raised the relative value of our foreign investment abroad probably by 20 or 30 percent.

So you know this terrible fear that we have become the world's greatest debtor nation, is another bit of overblown rhetoric.

Mr. SCHULTZE. Not the fact that being the world's greatest debtor nation. Unlike the 19th century, we piled up all this debt to consume it, not to invest it in productive assets.

Second, the problem is that the U.S. Government can do in the long run very damn little to raise our 1 percent a year productivity growth by as much as one-tenth of 1 percent. It is very difficult when you get away from all the rhetoric, to know what to do to change rates of growth by two-tenths or three-tenths of 1 percent.

The one thing we can do which will make a difference of one or two-tenths of 1 percent a year is doing something about our deficit situation. Granted, it is not huge. You have to be worried about people crying wolf, wolf, but in the context of what else we can do, this is one thing we can be confident of.

Mr. EISNER. Half of 1 percent on unemployment is going to do much more than that.

Mr. DOWNEY. The problem is, I have a certain kinship to your priorities, the reality is, if we were spending this to refurbish our infrastructure, send kids to school, one could make a more powerful argument that this is productively spent.

We are not doing that. One other point, the foreign debt, it seems to me, is at a point where over the next few years that we are going to have to run surpluses, are we not, in our exports in order to repay it, and I don't know how that is done with the Japanese, the Germans, the Koreans when they all base their economies on surpluses themselves?

I see it as a situation where really, it begs us to be responsible and to raise some revenue in very short order.

Mr. STARK [presiding]. Mr. Moody?

Mr. MOODY. Thank you, Mr. Chairman.

You said earlier that you proposed keeping the balance perhaps between the debt and GNP. Is that what you propose, or that there might be a more reasonable goal than some downward glide path? If you were to use the 50-percent ratio, wouldn't we lose the fiscal stabilizing effects of the deficit?

That is one of the major purposes of deficits: to balance the economy.

Mr. EISNER. Your point is well taken, but I was suggesting that as a target, as a starting point. To the extent you do want to use fiscal policy to try to influence the economy to push it up or down, from that point, from year to year, you might alter your structural deficit.

Mr. SCHULTZE. The only problem with that, if you ran $300 billion deficits for a while, built up a huge debt, then you would be okay to run even larger deficits in the future. It depends upon where you are starting from.

Mr. EISNER. That is right, we are starting from a 50-percent ratio. It is higher than in 1980, much lower than in 1946, after which we had a huge postwar boom.

That depends, as was suggested by Mr. Downey, upon what you think the Government's spending is going for.

Mr. SCHULTZE. It depends on, assuming you can get monetary policy in the right place, on whether you want to use your national

saving to finance a budget deficit, and you may, or you may want to use it for other things.

If you think the economy is running at too low a level, in order to be ginned up, that is one decision, monetary policy. Granted you got some kind of full employment, what do you want to do with your national saving, and how much to finance the budget deficit?

Mr. MOODY. The long-term implications of debt, you said, is not necessarily debt, but also equities. But we have to pay back earnings on equities to foreigners.

Mr. EISNER. You know, you have to always consider what is the alternative. I have argued that we should have easier monetary policy, drive down the value of the dollar. But suppose the Japanese now are investing in building an auto plant with General Motors or whatever, we don't have a debt to pay back, and if they know what they are doing, and GM knows what they are doing, we are going to have more products, and the earnings we will be paying back, we will be paying back out of the plant.

Mr. MOODY. That undercuts Dr. Schultze's statement. We may be borrowing it to build a capital structure in America.

Mr. EISNER. That is correct. The difference I have with Dr. Schultze, and we can argue it, you know, how fixed that pool of national saving is, how much lower you think you can drive the rate of unemployment.

The economy is slack, I think and the main goal should be to end the slack, and then we can have more investment and we can have more consumption as well.

Trying to cut consumption in a slack economy you will reduce investment, not increase it.

Mr. SINAI. The debtor position, the international debtor position is very small at the start, as a percent of GNP. The concern is not for the next year or two, but for those who call attention to it, an accumulation of that debt in conjunction with a still-high domestic debt.

Together, both rising as a percentage of GNP, that in itself is not necessarily a bad thing, either. It is when interest payments, debt service payments, get larger and larger, that there is a restraint. Control over those interest rates do not exist.

Mr. MOODY. Ultimately the capacity of the carrier?

Mr. SINAI. You can do it for a country and that then forces problems, one way or another. History is filled with such examples. Not us. I think we are still a long way away from this.There is plenty of lead time to work on this problem. But eventually it forces countries to somehow have to swallow austerity or inflate their way out of a situation. Neither one of those alternatives helps the standard of living of the people.

Mr. MOODY. If we try to fight our way out, drive down the real value of the dollar or exchange markets, then we will have to work harder, won't we?

Mr. SINAI. That process is self-defeating, providing only near-term relief. Whether the Federal Reserve does it or not, it is only near-term relief. Ultimately, the higher inflation will come back in the form of higher interest rates.

Mr. MOODY. Don't we get the same effect if foreigners decide they won't value the dollar as highly, so we have to export more real goods?

Mr. SINAI. That is right. That is the new element——

Mr. MOODY. Not that we repay the debt, but in order to carry the costs, we will have to work harder and harder to run in place.

Mr. SINAI. That is the new element in the ingredient. Here, I would disagree with Dr. Eisner, and that is on the role of the dollar and what it does to interest rates, and to the room for maneuver that our Federal Reserve now has. The dollar is now the mechanism, and much more important than in most of our postwar history, by which we can possibly regenerate inflation in this country, not through the traditional——

Mr. MOODY. Exchange markets.

Dr. Sinai, do you have a sophisticated model that would tell us what the cost of meeting the Gramm-Rudman targets might be, with these feedback effects, if we hit the economy too hard by meeting that target, and fiscally dampen it. Can you give us some numbers, not today, but another time?

Mr. SINAI. Well, I think in tables 4, 5, and 6 in the statement, there are some examples of impacts of making spending cuts, beyond what we assume the Congress would already make to get to the Gramm-Rudman-Hollings targets.

We would be happy to provide you with more detail.

Mr. MOODY. Finally, Dr. Schultze, you talked of a gas tax being socked to the consumer. At $5 a barrel, you say all gas would rise to that level. Isn't it possible that some or all of the burden would be shifted back to the foreign producers?

Say the level of gas price in the United States is set in America. With gas prices set at the pump in America, the price setting arena, foreigners have to eat the $5 tax. Say it costs $3 to bring a barrel out of the ground, Saudi Arabia——

Mr. SCHULTZE. 80 cents.

Mr. MOODY. 80 cents, so there is a lot of economic rent in their revenue. Wouldn't we be forcing their net return back down that economic rent curve by the $5 tax? Wouldn't we be shifting the burden back to the overseas producer?

Mr. SCHULTZE. The only way is the extent to which our fee cuts world oil consumption, thereby putting up to OPEC at least the question whether they have to take a price drop to keep production up.

If every country in the world did this, it might work to drive down prices, but if only we did it, and we import about a third of our oil and that third that we import, I forget what it is as a fraction of the world oil consumption, if we saved 10 percent on our imports, that is only 2 percent on world consumption, but the magnitudes are so small, I wouldn't put it on American consumers just for that.

Wherever industrial consumers did that, yes, but not just one out of many.

Mr. MOODY. You think the burden would be split?

Mr. SCHULTZE. Mostly we would take it in that case. If it were worldwide, the split would be different. One quick comment, we

have not been very careful in mixing up two different things this morning about the impact of the budget.

One, what is the level of economic activity that the economy is running and ought to be running? Should we have higher spending because unemployment is too high, and we want to get the total level of economic activity up by spending more?

Some 6.7 unemployment. At the moment, I would say 6, whatever. You can do it by easier money——

Mr. MOODY. If you can push on the string.

Mr. SCHULTZE. Real interest rates are high enough that you would be pushing on something more resistant then string if you lowered interest rates. The second question is, assuming you get to that level you want to get to, then the Federal budget deficit means you are soaking up savings that could have gone elsewhere.

Bob Eisner has been talking about the other problem. The United States is a low saving country, low productivity growth country, where saving is too precious to soak up in a Federal budget deficit to finance mainly consumption. Therefore, if you want to get higher levels of economic activity, go beat Paul Volcker over the head, don't say we shouldn't get the budget deficit down.

Mr. EISNER. I agree very much with what he just said, but the conclusion I take is, since he says we have to get to 6 percent—he would get to 6-percent unemployment—it is not a matter of increasing Government spending or raising, or reducing taxes rather, but do you want to cut Government spending and/or raise taxes in the face of this slack? You cannot yet say we have gotten to the point where the national savings pool is fixed.

Therefore, the logic of what Dr. Schultze just said is that you have to make sure you are getting to eliminate that slack, and it is in that context that you can talk about reducing the deficit, and I would pick up something he said earlier.

He said that the Fed, he thinks, would accommodate, although they might be more cautious than he would be, and that is the critical qualification. I would agree, they would be more cautious than I would be, unless apparently some pressure can be put on them, and we can be sure of that, and he has focused on a critical issue which I have been raising, which people have ignored.

I do agree with Dr. Schultze on the matter of energy taxes. If you are going to raise taxes by that way, much the better way is to have it on all energy, not just on imports.

Another argument is, if we are concerned about a long-run shortage, it is dumb to go ahead and say we are not going to use foreign oil, we are going to have an import duty against that to encourage ourselves to use more of our own oil. You might as well use the foreign oil and not discourage that with an import duty.

Mr. STARK. If the gentleman will allow, his time has expired.

Mr. Dorgan.

Mr. DORGAN. I just have one comment and one question, and I am sorry I have had to miss part of your presentation by necessity.

Sometimes I think that public policy makers and economists overestimate their role in shaping, guiding or even estimating where this economy might go.

We had business cycles before income tax and we had business cycles before we had a Federal deficit. Our economy seems to have

moved up and down and around before all of these things that we have been involved in trying to shape its direction and the economy will likely even survive this administration, surprising as that seems, given the fiscal policy we have had in recent years. So I sometimes think we overestimate our abilities. If you listen to some economists and politicians, they would give you a view of the ship of the state from the engine room with a whole range of dials, gages, levers, pulleys, and things and we know exactly how we tune this thing to make the engine run.

The fact is none of us really know very much. If we did we would be very, very wealthy. But, notwithstanding that, we probably make some differences at the margin and that is what this is all about.

I have a question about savings versus consumption, and Mr. Moody is smiling because I know he is an economist and I don't mean to—I taught economics myself very briefly and have not been able to overcome that, but lets look at savings versus consumption.

If I turn on the television tonight, I will see an ad from somebody that says I want you to buy my product. It does not matter if you can afford it or not. I am going to send you the product, give you a rebate, and you don't make the first payment for about 3 months.

We encourage people to consume immediately as opposed to defer consumption which represents a saving pool. In Japan, if you want to buy a house or automobile, they say you better save some money, because you need a significant downpayment to do that.

In order to take the slack out of the economy, I assume the slack you talked about, Dr. Eisner, is in part driven by a healthy consumption base in the economy. Yet if we want to encourage a significantly greater pool of savings, it is in conflict with our interest in consumption, So how do you deal with this? To compete with the Japanese, do we have to re-think this notion that you ought to buy things you cannot afford with money you don't have, or is there some imbedded conflict here in savings and consumption?

Mr. EISNER. I have great sympathy with what you said. We do exaggerate what harm and what good government can do to the economy, and regarding saving, I think the choice of individuals as to how much to save, contrary to what some of my colleagues say, not all of them, perhaps these colleagues will agree with me, is not one easily changed.

The American people have a notion what they want to save for, retirement, whatever, and they save about as much as they want to save and I don't think we should be trying to tamper with that much and we can't be very effective, and when we try to tamper with it, we distort the savings.

There are two ways that saving is affected and one is that the saving will be affected by how much businesses and others want to invest, and how much businesses want to invest will be determined by the prosperity of the economy. So generally more consumption, by making business more prosperous, stimulates more investment, thereby more income, thereby more saving.

The other way to affect saving is a matter of public policy. So much of true saving is public saving, saving by the investment in human capital and the government can have a very big role. This

is why so much of the discussion of budget deficits is so dreadfully out of focus. We say on the one hand we have to reduce the budget deficits so that our national saving will not be financing the deficit and then we entertain schemes to cut the budget deficit by cutting public investment, and true national saving.

The recession of 1981–82 was not an ordinary cyclical recession. It was in large part a result of mistaken government policy—too tight monetary policy and, correctly measured, too tight fiscal policy in a misguided effort to cut the inflation. The recovery from it actually has been to a very large extent a result of the much maligned budget deficit as well as some easing of monetary policy.

Mr. DORGAN. I have a healthy respect for all three of you. The panel is a very eminent, distinguished panel.

My concern about the economy these days is that, we have created an overly speculative economy in which the private sector rewards trading paper rather than producing real goods and folks come out of our business schools with MBAs wanting to emulate Ivan Boesky rather than Kaiser and Ford.

Do you see us developing a paper economic base?

Are you concerned about that?

Mr. SINAI. Actually, I don't see too many people wanting to emulate, T. Boone Pickens and the other people you mention. Most of the MBA's we see are extraordinarily hard working people and they have to work 100 hours a week.

You can ask whether what they do is productive, is a transaction-based economy productive? Our economy is now a services, transactions and information operation, not really a goods economy anymore, and there is a huge volume of transactions for every good that is built, and markets, being what they are, the prices that are paid for those services, wouldn't be paid unless there was something productive to it.

Whether you are building a store for productivity growth in the future by having such a large shift away from capital spending and investment in human capital, is a legitimate worry. That is a negative and the pendulum has swung too far and can detract from future performarce.

One other comment on the consumption versus saving question, I wouldn't tamper with it too much.

We have a fair number of clients who come in from Japan and they tell me that their savings habits are cultural. I think our spending habits are cultural. I don't think we can change it that much.

Americans probably save more than most of us think in deferred plans, pension plans, et cetera, so that the stated savings rate is a poor measure of the true amount of saving that is going on, equity in homes, and so on, and if you look at the full funds measure of saving, you wouldn't get quite as upset about our lower savings rate vis-a-vis other countries.

Mr. SCHULTZE. My colleague, Ed Dennison, at Brookings, he says the private saving rate in the United States has not changed, except in a narrow way in 100 years. The big way you can change national saving is what you do with the Government budget deficit or surplus and within the Government investment spending versus consumption type spending.

Those are the biggest single things you can do. With respect to the paper economy, let me fly loose. I have no great ideas. There is a potential difficulty that the United States has been going through in that the computer revolution—the information and communications revolution—has to date principally turned itself into ways of facilitating information and quick transactions, and therefore, tends to principally involve sophisticated financial and related changes. I suspect that all of this has not yet added terribly much to national productivity. I suspect that the problems which some of the go-go stocks, computer stocks are having arises from a growing, fundamental reevaluation on the part of business firms of the extent to which all of this computer-related investment has been adding to profitability, productivity. There is a national problem in the sense we have not yet learned I think as a business and national community how to take full advantage of the computer revolution.

My guess is that we will gradually work our way out of it and learn how to use the new technology better. But, while I think that is true, let's not have the Government try to do anything about it. If it is going to cure itself, it will.

There is not much that the Government can do to cure it.

Mr. DORGAN. Thank you very much.

Mr. MOODY. If I could presume on your time another minute. Yesterday I had a dispute with the Secretary of the Treasury about the sale of Government assets as a way of reducing the deficit. He insisted that this was a legitimate way of reducing the deficit.

I argued that it was exactly like bonds. You are taking Government paper and selling it to the private sector. That occurs whether it is a loan portfolio, or whether it is bonds that you print up on our premises here. Either way, you have taken private investable funds and cycled them into government. In financial terms you have gotten some cash now, and an obligation later, with bonds, higher interest costs later so your net fiscal position is identical. I could not get the Secretary of the Treasury to agree with this.

Am I off base in insisting that those are equivalent activities—selling a loan portfolio and Government paper in the form of a bond?

Mr. SCHULTZE. You shall make the distinction between the use of asset sales for Government management purposes, where it might be useful.

Mr. MOODY. There may be merit.

Mr. SCHULTZE. Ninety-nine percent of it should not be counted against reducing the Government deficit for the reasons you gave, and it is literally smoke and mirrors and not doing anything for you.

Mr. MOODY. Well, thank you.

Since we all agree that the Gramm-Rudman targets are too stringent, maybe we should encourage more asset sales in the form of bonds?

Mr. EISNER. You are so correct. It is sort of astonishing that the Secretary would argue with you. Almost any economist would have to agree that you are absolutely correct and I also would have to say, though, that given the problems you suggest, meeting the targets, more phoniness would be better, but I hate to put up with it.

Mr. STARK. Mr. Pease.

Mr. PEASE. Thank you, Mr. Chairman.

First, I appreciate the testimony of the panel. I wasn't here for all of the testimony and I am sorry I had to leave. I may repeat questions that have already been asked and, if so, I am sorry.

We have been talking a lot about deficit reduction. Obviously we can reduce the deficit by reducing military or domestic spending, by asset sales, by revenue increases, user fees or actual tax increases. Some people seem to think that it would be a mistake to use revenue increases as part of the equation.

I guess my question is, do any of you feel it would be better not to reduce the deficit at all or not to reduce it as much rather than to use revenue this year as part of the deficit reduction effort?

I am sorry Mr. Greenspan is not here. He might take that position.

Would any of you take that position? Say, we set out to reduce the deficit by $40 billion this year, $20 billion for revenue and $20 billion from spending reductions, and someone said, well, it is a mistake to raise revenue. Would we be better off reducing the deficit by only $20 billion and not having any revenue put in place or not?

Could you comment on that?

Mr. EISNER. I will perhaps take the extreme position that there are certain expenditures that I would like to have reduced and I have already alluded to the main category, but in terms of the overall budget, the critical question is where the economy is going.

I rather agree with Dr. Schultze, if we do reduce the deficit, the Fed will accommodate. Any reduction of the deficit in this state of the economy in itself will be a drag.

I, therefore, establish no high priority in reducing the deficit except to the extent I can exact it as a way of easing monetary policy and lowering the value of the dollar and restoring our trade position, and/or if I could use reducing the deficit to reduce those expenditures which I personally consider extravagant and a menace to national security. As for reducing the deficit by revenues or cutting expenditures, I do think that is something of a canard which is put on the American people.

The incentive effect of higher tax rates at this point, or any other increase in taxes will be trivial. If you raise taxes, perhaps the cleanest thing to do is to raise the rate a percentage point or two and you get a huge amount of revenue. But that is not the problem. Either raising taxes or cutting expenditures, you take away fiscal stimulus and you have to ask, how much fiscal stimulus can we afford to take away at this juncture?

Mr. SINAI. You are better off using revenue and spending reductions, a combination of that, than not.

The problem with the Federal budget deficit being so high is that along with an emerging turn in our trade deficit, the combination of the two will actually, as time goes on, give us more strength. The dollar too, has an effect on inflation.

Three to 4-percent inflation, which is what most expectations are, is on the borderline of what is benign in terms of problems for our economy.

We used to say 2 percent was about right; 5 percent or more is clearly unacceptable, and so better to do that than not to do anything at this stage.

Mr. PEASE. I presume you would agree?

Mr. SCHULTZE. It seems to me you ought to get the budget deficit down to about $40 to $50 billion, and in turn, both substantively and in terms of political feasibilities, it ought to be done, importantly by taxes, maybe 50/50, maybe even something like that.

Taxes will have modest disincentive effects but they can't compare to the gains you will get by reducing the deficit. So, yes, I would say a tax increase ought to be in there, and if—and there will be some harm but less than the harm that would come by not reducing the budget deficit.

Mr. PEASE. Let me ask one final question about the relationship between Federal fiscal deficits and our trade deficit. We are very much involved in the trade issue right now on this committee.

Many economists seem to suggest that the fiscal deficits have a very direct and specific relationship to the trade deficits. Would you agree with that?

I also understand that some economists don't think reducing the fiscal deficit by increasing revenues has any beneficial effect on the trade deficit. The only benefit to the trade deficit comes from reducing fiscal deficits through spending cuts, not through increases in revenue.

I have a little trouble following that. I wonder if any of you could comment in a way that might help me.

Mr. SINAI. I think the linkage is the following: We had very large budget stimulus early on, the big Federal budget deficits, and they were huge, the greatest fiscal stimulus since World War II.

Along with that was the monetary growth targeting policy of the Federal Reserve. It combined to cause much higher interest rates than would have otherwise occurred and they are still a lot higher because of the deficits.

The stimulus of the budget deficit had an income effect. American consumers bought a lot more and so did business in 1983–84. The dollar went way up, our economy grew fast, interest rates were high and we substituted foreign goods for our goods and we lost shares of our markets and that is how the linkage works to our trade deficit.

Once you get the big trade deficit, it does not reverse symmetrically. You don't reverse the trade deficit the way it built up through the dollar going the other way.

We don't want the kind of recession that would be necessary for our trade deficit to get a lot stronger.

The second part of your question, which was the difference between raising revenues, I could see where raising revenues would help our trade deficit, cutting spending down both here and abroad. Of course, cutting spending would do the same, Government spending would do the same thing but revenue increases, from households and/or business, if money is taken from those sectors, they are going to buy less from abroad and our imports will not rise as much.

If you cut Government spending, we also will take income away from households and business, but indirectly, and I don't think I

follow the logic of spending as the preferred way to cut our budget deficit.

Mr. PEASE. That might have been a bias on the part of the person who testified.

Mr. SCHULTZE. There is an esoteric economic theory which has gained some credence among some of the young hot shots in the profession, which I find absurd.

It runs as follows: that taxpayers and consumers are infinitely altruistic and who think about themselves and the descendents.

When you cut taxes, they realize it will build up debt to be paid off later.

They save now to compensate for that and, therefore, raising—I am oversimplifying—raising or lowering taxes, or the deficit that way has no impact on the economy because people save and it does not affect interest rates or anything.

How this happens in a world in which we have gone from a very low deficit to a deficit of last year $220 million, importantly because of tax cuts, and saving didn't respond, I don't know, but that is what the theory says.

You may have gotten it from that economic theory.

Mr. PEASE. OK. Thank you.

Mr. MOODY. Will the gentleman yield?

The old textbook analysis, you pump in $2 trillion—I am sorry, $1 trillion—of stimulus in deficit spending which this government has done over the last 5 years—and unemployment went from 7 percent when Reagan took office to just slightly less than 7 percent until recently when it dropped a little below that.

Where did all that stimulus go?

The analysis is, related to Don's question, that we gained some stimulus all right, but we stimulated jobs in Taiwan, Korea, in Japan. Is that the way to go?

Mr. EISNER. Remember that stimulus did not come along in the beginning of 1981. We started talking about cutting taxes. If you measure the budget deficit correctly, you will find the swing is about the middle of 1982, where we actually begin running substantial real deficits, and they contributed then to a reduction in unemployment from 10.7 to 6.7 percent.

I won't say they were the entire contributor, but you are correct that this did spill over into purchases abroad.

As Dr. Sinai said, there is no getting away from the fact that when consumers consume they sometimes consume at home and abroad. In order to reduce their consumption abroad, do you want to cut total consumption?

That will injure the economy.

Mr. MOODY. Isn't a lot of the stimulus exported?

Mr. EISNER. That is correct. That will happen in open economies and we find that we have helped with our deficits to stimulate foreign economies and bring them up further than they would have been.

That has been past history, that foreign economies have been particularly sluggish in the last few years.

Mr. SCHULTZE. A seven-letter word, beginning with V-o-l-c-k-e-r. When the fiscal stimulus hit the economy, he was determined it was not going to overstimulate and he put the brakes on.

Mr. MOODY. That pushed the stimulus abroad, those two actions in combination.

Mr. SCHULTZE. Yes, but not all of it.

Mr. SINAI. There are costs and benefits of the policy but of consumer goods we buy, 12 percent comes from abroad; 8 years ago the figure was 5.5 percent. Of business equipment spending, 37 percent, including autos and trucks, of what business buys comes from abroad. The figure 8 years ago was 12 percent, so this time around there has been a greater leakage of that stimulus abroad, I believe, than in prior years, and well, yes, those numbers are bigger.

Mr. EISNER. I do agree with Dr. Schultze, that Federal policy of undue restraint contributed to the——

Mr. SCHULTZE. I didn't say it was undue.

Mr. EISNER. I am sorry.

Mr. MOODY. Thank you very much.

Mr. PEASE [presiding]. Thank you, gentlemen. I appreciate very much your spending so much time with us. This will conclude the hearing. The committee will meet again subject to the call of the Chair.

[Whereupon, at 12:15 p.m., the hearing was adjourned, to reconvene at 9:30 a.m., Wednesday, February 25, 1987.]

# FISCAL YEAR 1988 BUDGET FOR HEALTH AND HUMAN SERVICES, AND WELFARE REFORM

WEDNESDAY, FEBRUARY 25, 1987

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
*Washington, DC.*

The committee met, pursuant to notice, at 9:36 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman ROSTENKOWSKI. Today the committee will examine the fiscal year 1988 budget of the Department of Health and Human Services and the President's welfare reform proposal.

Our only witness this morning will be the Honorable Otis Bowen, Secretary of the Department of Health and Human Services.

Dr. Bowen, welcome to the committee.

The budget that the President has recommended for your Department, and his welfare reform proposal, would have a significant impact on a number of programs under this committee's jurisdiction. Spending reductions have been recommended in the Medicare, AFDC, and child support programs. In addition, any welfare reform proposal, be it the White House report or the work and training programs in your Department budget, will require substantial changes in the AFDC program.

It is important for the entire committee to get an overview of these issues. Your testimony today, Mr. Secretary, will be useful as we prepare for subcommittee and full committee action on these proposals.

I look forward with my colleagues to your testimony and to working with you in the coming months. It is a pleasure on a personal note as well, Mr. Secretary, to welcome you. Because you are from our sister State of Indiana, I have known your record, and have great admiration for the way you have conducted yourself in public life. Your reputation precedes you and I am proud you have taken time to join us.

Secretary BOWEN. Thank you.

Chairman ROSTENKOWSKI. And now I would like to recognize a fellow Hoosier. One who I have been in that State campaigning for on one or two occasions, and who I have grown to have a great affection for, our good friend, Andy Jacobs.

Mr. JACOBS. Thank you, Mr. Chairman.

It is a privilege and really an opportunity, since Dr. Bowen lives in and votes in the district I have the honor to represent. He is my

constituent so I will make a pitch for your vote, Doc, while I welcome you to the committee.

I would like to take just one second to spread on the record a story that will illustrate the kind of person Dr. Bowen is who puts his country ahead of his party, and any other private considerations.

A few years ago, my father served as criminal court judge in Indianapolis. He got disgusted with the Indiana Supreme Court, which we all do from time to time, and tendered his resignation, which meant that Dr. Bowen, then Governor of Indiana, had a juicy political plum appointment to make. He could appoint a person to that court. Instead, he called my father and persuaded him to serve on because he believed that it was in the public interest that that happened. That is the highest order of bipartisanship. Greater love of the public hath no public servant than to lay down a political plum for the sake of the public good.

So, out in Indiana, we say that Dr. Bowen is like the old Sarah Lee cake ad, that nobody does not like Doc.

So, welcome, doctor.

Secretary BOWEN. Thank you, Congressman.

Chairman ROSTENKOWSKI. Mr. Secretary, welcome. Please proceed.

**STATEMENT OF HON. OTIS R. BOWEN, M.D., SECRETARY, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES, ACCOMPANIED BY THOMAS R. BURKE, CHIEF OF STAFF; AND HON. ROBERT B. HELMS, ASSISTANT SECRETARY FOR PLANNING AND EVALUATION**

Secretary BOWEN. Good morning, Mr. Chairman, and distinguished members of the committee. With me today are Tom Burke, on my right, my chief of staff, and Robert Helms, the Assistant Secretary for Planning and Evaluation.

I appreciate the opportunity to appear before you to discuss both welfare reform and the proposals in the President's fiscal year 1988 Health and Human Services budget.

Mr. Chairman, the programs we will be addressing this morning form the very heart of the Department and affect the lives of millions of this Nation's citizens, including Medicare, Social Security, aid to families with dependent children, and supplemental security income.

We are all sitting in this room today for the same purpose: we want to do what we can to foster the health and the well-being of the American public.

We recognize that you will not adopt this budget intact, nor do we expect that you will reject it in total. Instead, I hope you will receive this budget in the spirit in which it was crafted: it is our plan for promoting the Department's mission while achieving the mandated budgetary goal.

There is much talk about the budget driving health and social services policy. And I would like to dispel that rumor today. There is no room for such an idea on my agenda as Secretary of the Health and Human Services.

While it is true that we all face some very challenging budget targets, this budget highlights a solid core of common sense provisions with worthwhile public policy goals.

And while it is not a formal part of the budget, a high priority for enactment this year will be the Medicare Catastrophic Illness Coverage Act.

Nothing poses more of a threat to the elderly than the fear of financially devastating catastrophic illness. This legislation will provide much deserved peace of mind to our Medicare beneficiaries.

Now, let me first briefly present the highlights of our budget and, with the chairman's permission, I will provide a more detailed description for the record.

For fiscal year 1988, we are proposing a Medicare budget of about $75 billion. This represents a net increase over 1987 of 2 percent. With our reforms, we predict that Medicare still will grow at an average rate of nearly 8 percent over the next 5 years.

Our Medicare proposals have four themes: advancing the private health plan option; assuring quality health care; promoting increased competition and efficiency; and increasing beneficiary participation.

As this committee is well aware, Medicare first entered into risk contracts with health maintenance organizations and competitive medical plans on a broad scale in 1985. The private health plan option builds on this successful concept, allowing beneficiaries and providers broader opportunities to participate in Medicare through private health plans.

The expanded choice option would provide us with broad authority to contract with a wider array of private plans, such as indemnity insurers and service benefit plans. We would pay these plans 95 percent of the projected cost of Medicare benefits in the fee-for-service system.

The employer-based plans option would permit these plans to assume responsibility for providing Medicare benefits to their retirees in exchange for a fixed government contribution.

Our budget intensifies the efforts currently underway to ensure quality of care for our beneficiaries. We will spend approximately $176 million on peer review organization activities, refocusing the scope of work not only on utilization review but toward quality of care review.

Other components of this effort include: monitoring the quality of care provided to Medicare beneficiaries enrolled in HMO and CMP plans; increasing funding for State survey and certification activities so that nursing home services are provided in facilities which meet the highest health and safety standards; and promoting a research budget which will fund quality of care-related studies.

Our budget also aims a number of proposals at refining the prospective payment system and reducing overpayments in services still paid on the basis of costs. We also propose regulatory and statutory changes to repeal costly program expansions enacted last year in the Omnibus Budget Reconciliation Act of 1986.

Finally, the Medicare budget proposes modest increases in beneficiary cost-sharing. I understand, and I share, the committee's re-

luctance to impose any hardship on our most vulnerable Medicare beneficiaries. However, I would ask that you keep an open mind on this proposal. We continue to believe that a modest level of cost-sharing is a legitimate means of ensuring appropriate utilization of services without undue hardship for beneficiaries.

Let me turn now to the Human Services portion of this budget.

One of my central priorities as Secretary is to strengthen the family and to ensure that our public institutions support and not undermine family life. Our legislative proposals for the child support enforcement and AFDC programs have two basis thrusts to enhance self-sufficiency—to increase payments by absent parents in support of their children, and to increase work opportunities for custodial parents.

While States are in varying phases of implementing the 1984 child support amendments, we have not seen dramatic increases in collection levels or decreases in administrative expenses. There is the need now for a greater stimulus to improve the effectiveness and efficiency of the child support enforcement program.

Our two major child support proposals will further emphasize cost-effective operations by, No. 1, requiring States' use of support-order guidelines to increase allocations and collections and help prevent dependence on AFDC and Medicaid and No. 2, modifying the Federal financing of the child support program.

I am particularly enthusiastic about our new work program proposal for AFDC recipient, which is part of the President's Trade Employment and Productivity Act of 1987, and gives recipients a chance to achieve real self-sufficiency.

We all can agree that more attention needs to be focused on recipients who are likely to remain on welfare a long time, such as unwed teenage mothers with small children, and those who lack the basic education and work experience needed to become independent.

The GROW program would require most able-bodied adult recipients, including those with young children, to participate in activities leading to self-sufficiency. Teenaged parents and dependent children, aged 16 to 18, with less than a high school education will be required to participate in an educational program.

States will have great flexibility to design their programs based on local and individual needs and circumstances. Federal matching funds under the AFDC program will be available on an open-ended basis to cover 50 percent of the States' costs of operating the program, aside from education and training activities, including the necessary support services such as child care and transportation.

The main focus of the Office of Human Development Services (OHDS) in 1988 will be to implement broad social services strategy to target the most needy in our society. Along these lines, the fiscal year 1988 budget funds the State social services block grant at the full authorization level. And we request a generic appropriation of $2.2 billion for a wide array of social services programs in order to better focus resource allocation decisions on the overall direction of Federal social services policy.

Our request for foster care and adoption assistance assumes enactment of a legislative proposal to limit State administrative costs

and save $84 million without reducing the reimbursement payments made to families on behalf of foster and adopted children.

I would like to turn to the administration's proposals related to Social Security, which include several proposals to expand Social Security coverage. These proposals would result in improved Social Security protection for agricultural and student workers, Armed Forces reservists, and certain individuals employed by relatives. Protection would also be expanded by conforming the Social Security treatment of group term life insurance to the income tax treatment.

Another proposal would require employers to pay Social Security taxes on tips, which would end the disadvantage to the Social Security trust funds which occurs because covered tips are used to compute benefits but are not fully subject to Social Security employer taxes.

There is also a management improvement initiative that would modify the requirement for Federal review of favorable State agency disability decisions in the Social Security disability insurance program.

Turning now to welfare reform, I have briefly highlighted the Department's own GROW proposal which is part of the President's budget.

There is, however, a major White House initiative aimed at reforming the welfare system which certainly warrants your most serious consideration.

In his State of the Union Address for 1986, the President charged the Domestic Policy Council to complete a study of the whole system of public assistance programs, and make recommendations for a strategy "to meet the financial, educational, social and safety concerns of the poor."

The report, entitled "Up from Dependency: A New National Public Assistance Strategy," included recommendations which the President adopted to seek authority from Congress for wide-ranging demonstrations of alternative welfare programs.

In a February 6 letter to the Governors transmitting the report and inviting them to the White House to discuss the prospects for welfare reform, the President wrote, and I quote, "Restructuring our system must be a top national priority. The Federal Government must retain its current level of financing, but individual States and communities can best find the solutions to welfare dependency."

Let me say, as the Secretary of the Federal department with the largest number of public assistance programs, I know what the President means when he says that "despite our intentions, the welfare system is failing; the system traps people in a cycle of dependency that robs them of dignity."

And as a former Governor, let me tell you that it sounds pretty good to Governors to hear the President saying that they will be given the flexibility to try to make welfare work better. Many Governors have been trying to do that within the flexibility currently allowed to them. But we can and should do more to give them a chance to succeed.

I will not try to summarize everything that was in the report and the supplemental volumes. Let me just say that the low

income working group, on which Dr. Helms served, looked at a wide variety of information to come up with their recommendations.

It is not that we do not know anything about improving public assistance. For example, the GROW work activity program included in the budget this year has several years of sound research and demonstration behind it. However, our proposal is limited to AFDC recipients. When it comes to sweeping changes to restructure the whole system of public assistance programs, we have to say honestly that we do not have the research and demonstration basis to know what will help and what may hurt.

There will be many proposals for sweeping restructuring of our complex public assistance system coming before this committee. And I hope the committee will be resolute in demanding to know just what basis the proponents have for believing the proposals will both meet the needs of the poor and reduce dependency. In that case, I am confident that the committee will come to the same conclusion as the low income opportunity working group. Before we make changes to the system as a whole from the top down, we should seek evidence from the bottom up about what works in real communities and States.

There is no doubt that our budget poses a challenge. Since a full 96 percent is entitlements, you simply have to look at program reforms in order to hold down spending and meet the Gramm-Rudman-Hollings targets.

We must look at how the programs are working, see what we can do to make them more efficient, to strengthen them, to hold down the rate of spending, and all the while preserve the mission of this, the people's department.

So the message I want to leave with you today is very simple. We do want to work with you, and none of us has all of the answers to the complex problem with which we must grapple in order to serve the millions of citizens who rely on us. Only by working together can we begin to address what needs to be done.

The President's budget, submitted to you on January 5, represents the opening in what I hope will be a full and ongoing dialog. And I want to pledge the resources of my Department and of my senior staff as we move together toward a closer examination of the proposals that we have advanced.

Mr. Chairman, this concludes my oral remarks. I will be pleased to answer any questions you may have.

Chairman ROSTENKOWSKI. Thank you very much, Mr. Secretary.

Mr. Stark.

Mr. STARK. Mr. Secretary, I want to welcome you to the committee and welcome your testimony and reiterate what has been said before by the chairman and my colleague from Indiana, that it is indeed a delight having you in the position in which you serve. I know from our experience over the past Congress particularly in working in the Medicare area, that you have been willing to compromise and work with our Health Subcommittee. And we look forward to doing that again this year.

I am pleased that the administration has seen fit to take your lead and work with us to establish some increased benefits. I wish we could find a better name than catastrophic because we really do

not remove all of the potential for financial catastrophe from Medicare beneficiaries, but I think we take a giant step forward, whether it is in the administration's bill or in the bill which Mr. Gradison and I and Chairman Rostenkowski intend to introduce tomorrow, which is very similar and fits within most of the guidelines which you established earlier.

I think the result will be increased benefits to the beneficiaries, increased efficiency in the medical delivery system, and a step toward expanding those benefits for all Americans.

I have some concerns, and I would voice those now in a spirit of constructive criticism and ask you to comment on it.

I understand the administration's urge to have options to contract with medical care providers. My concern stems from my experience years ago in the financial field. At one point, I owned both a savings and loan and a bank. I was regulated by two different groups, the Comptroller of the Currency and the Federal Home Loan Bank Board. And the Federal Home Loan Bank Board regulated in those days by the letter of the law. Literally, when they made a single-family mortgage, they gave you a book of a thousand pages on what kind of a pencil the appraiser would use, and whether he had to make the appraisal before noon or after noon, and what kind of education, and how many pages the note would comprise. I mean they went through great detail.

The bank regulators had 500 words. They said you will make a loan not to exceed 80 percent of a reasonable appraisal, and we will amortize it during the length of the loan, and it will not be over 30 years paying.

And when you came in to be examined, the savings and loan examiners would complain about this loan, and you would write eight pages back. And nobody ever really got down to the issue, is the loan any good? You fought over these regulations.

On the other hand, the Comptroller of the Currency would come into a bank and say that loan is not any good. You could argue a little, but you knew you were dealing with somebody who understood. If it was not any good, he wrote it off.

I am hearing two different kinds of reactions now from health maintenance organizations, for instance. Some are complaining that there is too much detailed regulation. Others are complaining that there is not enough. They do not know what to expect next.

I guess what I am suggesting is that in expanding into those new fields, which I support, I would urge that we go slowly, perhaps more slowly than the administration would like. Not because I think you will find any philosophic objection from this member or his committee, but only that you are dealing with an industry that has worked so long by tradition. for example, to my knowledge you have no regulations on financial working capital requirements or reserve requirements, which are very much part of regulating an insurance company, but which we have not even begun yet to think about. If we contract and give 95 percent of the Medicare payments to a new organization which, say, does not own a hospital and has no physicians working for it on salary, how much of those premiums do we require those people to keep in the form of working capital or reserves? I do not think we know.

And I do not think that we are prepared to legislate yet, and I am not sure you are prepared to write regulations. I hope we find out, through reasonable expansion of these alternatives. I hope we do not find out when some slick operator takes our Federal money and goes south, leaving thousands of Medicare beneficiaries stranded without their promised benefits.

I hate to be the harbinger of doom and gloom, but I am hoping that we can find a way together to expand in this field and avoid this potential. That is the one sense of reluctance, if I may use that term, that I have to expand willy-nilly into these new fields.

I hope that we can work out a system together that will avoid that, and provide your operation with a staff and the legislation it needs to regulate some of the existing programs, and then expand as we find that there is the ability of these people to carry it out.

I do not feel that the general market forces work with individuals who are buying medical care. If shopping for a home or a television set, they can understand what they like and do not like. But for the person who generally makes those decisions when he or she is very sick, they just do not have the choice. And we have to do that for them.

It is unlike most dealers with private enterprise. The government in this case has to help those people make that decision because generally they are not in a frame of mind to make it as rationally as they should once they are ill.

Other than that, I welcome the opportunity in the months ahead to work with you in this area of Medicare reform that you have testified on today, and I look forward to receiving more of the details on your expanded options in your employer-based plans.

Secretary BOWEN. Thank you very much, Congressman.

The admonition to go slowly, I think, is well taken. Gathering accurate data, of course, will be necessary so that we can carefully and accurately act, always keeping in mind things we must have, such as the access to care and the need to maintain quality of care.

Mr. STARK. Thank you. Thank you very much for your testimony this morning.

Mr. PICKLE [presiding]. The Chair recognizes Mr. Gradison.

Mr. GRADISON. Dr. Bowen, it is a great pleasure to have you with us today. You have done an extraordinary job of bringing to the administration's attention, our attention, and the attention of the Nation, some of the important unfinished business in the fields within the jurisdiction of your Department. You certainly deserve a lot of credit for doing that, and I want to join in the comments made by my colleagues on the other side of the aisle.

Mr. Chairman, I do have a few specific questions that I would like to explore, starting with one dealing with the question of the premium that would be required under your catastrophic plan.

As you may know, the Congressional Budget Office, in early projections which they have made available to us, has indicated that the calendar year 1988 premium for the benefits which you priced out at $4.92, for this year, may be as high as $6.40.

I would be interested in knowing what your latest estimates are of the level for that premium and whether you have available any further projections as to what it may be in subsequent years?

Secretary BOWEN. First, let me say that the Congressional Budget Office uses a different baseline to determine its calculations. As the initial study on catastrophic was conducted by the Department, we relied on our data base and the administration baseline to arrive at our figures. And we were recently made aware of the figures that you cited from the Congressional Budget Office, and we are working with them on the premium calculation.

We certainly want to express our willingness to work with your staff to correct whatever errors there may have been.

Mr. DAUB. Would the gentleman yield on that point to me just briefly?

Mr. GRADISON. Of course.

Mr. DAUB. Mr. Secretary, I had asked several weeks ago for all of the data that the Commission used and that you used to calculate the original $4.92, and I still have not yet received it.

Is it possible that within a day or two I will get all of that information?

Secretary BOWEN. We will get it to you, sir.

Mr. DAUB. I would like to have it. Our staff does not have it and I do not have it. It has been 2 weeks and I would appreciate it if we could get that information.

Secretary BOWEN. We will do our best to get it to you.

Mr. DAUB. You do have the substantiating documents for the original calculation of $4.92, do you not?

Secretary BOWEN. Yes, we do. Our actuary has that.

Mr. DAUB. And I can have that information, your original calculations?

Secretary BOWEN. Yes. We will get it to you.

Mr. DAUB. Thank you, Mr. Secretary.

Mr. GRADISON. Mr. Secretary, this question of the estimates is important and, indeed, the question of whether the $4.92 or the $6.40 is in the ball park has been a matter of concern to many people here and elsewhere.

Are you satisfied that if we want to do a cross-check, a double-check of your own actuarial figures, that CBO would be the place for us to turn, or would you suggest that we turn to some actuarial organization on the outside? I think that we are at a point where an independent second opinion, if you will, might be useful to all of us in this matter, and I think it might be useful if we could discuss now or later who would be considered, or what organization would be considered a reputable place for us to turn for that second opinion.

Secretary BOWEN. We have no objection to that. I would state that the $4.92 figure has been checked and rechecked by our own actuaries, and they swear that they are right. But again these were 1986 computations. So the $6.40 figure for 1988, 2 years later, may be accurate.

Mr. BURKE. Congressman, there is a $5 billion difference in the CBO baseline and HHS baseline that accounts for a good part of that.

There is also a different administrative cost included into the CBO estimate than we have included in ours.

This third problem is that the CBO estimate uses a different time frame than the HCFA actuaries used. They started at a different point of time and ended at a different point of time.

Those three discrepancies, we feel, account for the difference.

Mr. GRADISON. Mr. Secretary, yesterday Governor Clayton and several other Governors testified before this committee and told us that the President had agreed to several parts of their employment and training proposals in the welfare reform area.

I would like for you to clarify for us, if you can, what the administration has agreed to and what it has disagreed with, and what questions there are that we should explore further.

Let me ask first, has the administration agreed to allow States to fashion their own welfare to work plans by using the community work experience, WIN, with demonstration and similar programs that currently exist?

Secretary BOWEN. Yes. They want to allow as much flexibility as possible in the development of the programs. But what may work in one State may not work in another, and the flexibility is necessary.

Mr. GRADISON. Mr. Secretary, has the administration agreed that States should be required to include all AFDC mothers with children, aged 3 or older, in the requirements for work training, et cetera?

Secretary BOWEN. Yes. In fact, our proposal of GROW, or greater opportunities through work, would even go lower than that. We have stated that mothers with children of 6 months of age and up would be required to enter into a work program.

The Governors, I think, said 3 years. And the answer is yes. But we would even like to go lower.

Mr. GRADISON. Mr. Secretary, has the administration agreed to spend in the neighborhood of a billion dollars beginning this year in order to finance these programs?

Secretary BOWEN. No. That is where the disagreement comes in.

Mr. GRADISON. Mr. Secretary, has the administration agreed to split the costs with the States at a percentage greater than 50-50, or what sharing do you have in mind?

Secretary BOWEN. Not to my knowledge has there been any agreement on that. I think it is something that needs to be discussed and compromises reached.

Mr. GRADISON. Very good.

And, finally, on this matter of welfare reform, will you be sending to us suggested legislation to the extent that legislation is needed in order to implement your welfare reform proposals and put these proposed new agreements into law?

Secretary BOWEN. Yes. Our GROW proposal has already been submitted, but I understand the other proposal has not been submitted but will be in the next day or two. I think the reason was you did not know where to put it when it got here. I think that is what they are discussing now.

Mr. GRADISON. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

Mr. PICKLE. The Chair recognizes Mr. Downey.

Mr. DOWNEY. Thank you, Mr. Chairman.

Secretary Bowen, I think that history is going to remember you fondly for the work that you have done in catastrophic health care coverage, and I congratulate you for it. And I add to bouquets that have been added by Mr. Stark and Mr. Jacobs to the work that you have done.

I am interested in talking to you a little bit about the welfare reform proposal and also about Medicare. But first if I can talk about welfare.

Let me quote from your testimony on page 12, you say, the President means what he says when despite our best intentions, the welfare system is failing. The system traps people in a cycle of dependency that robs them of dignity. That is on page 12 of your statement.

On page 13 of your statement, you say when it comes to sweeping changes to restructure the whole system of public assistance programs, we have to honestly admit we do not have the research and demonstration basis to know what will help and what may hurt. And we know it is not working. You said that on page 12.

And, on page 13, you say give us the time to take a look and the flexibility to try and determine what sort of system will work.

Doctor, we have studied this issue for the last 10 years fairly thoughtfully in the States, and there are a number of proposals that are currently pending that would deal with the question that you want to deal with, that are child support enforcement, greater work involvement for young mothers.

Do you not really think that now is the time, not 5 years from now to get on with the business of developing a system that understands the problems of the past and tries to appreciate what we have learned in the past as well? I mean you cannot have it both ways. You cannot in one sense say that the system has failed and, on the other, say we have got to wait another 5 years to figure out how we can make it work. We really cannot wait another 5 years to make this system work.

Secretary BOWEN. Sir, if you will permit, I would like Dr. Helms to answer that. He served on the White House's working group.

Mr. DOWNEY. Fine.

Mr. HELMS. The working groups looked at that question very carefully.

We do think we have very good research about the problem of long-term dependency, how successful work requirements really are, and the importance of education. Those issues are addressed in our GROW proposal. We can and are making specific proposals for the AFDC population that we think will work now.

But the problems with the public assistance system and dependency are broader than this. After going out and talking to many people around the country, we found that existing law constrained State and local governments from trying a lot of other innovative ideas and programs. Thus we are proposing more opportunities for developing solutions. Some of the ideas that have been proposed in Congress we would like to see demonstrated at the State level. There are lots of different ideas that should be tried.

Our intent is to let States with good proposals come forward and experiment with new ways to provide assistance more efficiently and effectively. There are also strong evaluation requirements in

the bill. Let us put these innovative ideas to the test and see what strategies work well.

Mr. DOWNEY. Okay. Well, let me just say that I appreciate the administration's position and your answer. But we are somewhat impatient here to get on with the business of dealing with this. And my guess is that we will this year. Indeed, Mr. Ford and others have put us on a fairly fast schedule, the Speaker in particular, to write a welfare reform bill. And we hope that in that process, you will work with us.

Let me ask you another question. One thing that does not have to be open to too much scrutiny is the tremendous disparity of payments to the poor in this country. I think you will admit that welfare, and particularly the problems of the poor, are national problems. I mean people in Michigan, Iowa, and Indiana are affected by the national economy, as well as people in the south, in Louisiana and Texas.

Does this Administration propose anything to equalize the payment to the poor? A family of four in Arkansas receives a payment of $224 a month in terms of welfare support. A family of four that is poor in my congressional district received $706. Now, I am not suggesting they should receive that much, but is there any proposal forthcoming from you that would attempt to equalize the disparity of being poor in this country? Admittedly, it costs less to live in Arkansas than it does in Suffolk County, N.Y. But it does not cost that much less.

Mr. HELMS. The working group looked at that problem. The requirements and conditions of the poor vary widely, and solutions may similarly vary in local areas. The basic premise of the demonstration strategy is to see what works at the local and State levels, not to impose any kind of national standard.

We have in our GROW proposal a requirement to up the participation rate of the AFDC population in work and education programs and we think that will give a strong incentive for States to go out there and use what they think is best for their particular situation.

Mr. DOWNEY. Well, I agree that flexibility for the States in the GROW proposal is a good idea, but I blanche a little bit at the idea that the 6 or 7 percent of the people who are poor in this country cannot work because they are too old, and another 38 percent of them cannot work because they are too young.

Now, some of them may live in families where the mother or father can work, but that does not—the GROW proposal is not going to help a lot of poor people in this country who have absolutely no other way of living other than to rely on food stamps and AFDC. What are we going to do about them? Why is not poverty considered a national problem? Why is it not appropriate for us to set national standards for people who are in need?

Mr. HELMS. We think that would be going against the principle of local determination of these problems. Certainly we saw a wide variety of problems in our studies of this. We would like to see more State flexibility in doing experimentations.

And I do not have to remind you, when you get to talking about setting national standards for benefits up to the poverty level, you are talking about a very expensive proposition, not only for the

Federal Government, but particularly for those States which do not now have high benefits.

Mr. PICKLE. The Chair recognizes Mr. Pease for inquiry.

Mr. Pease.

Mr. PEASE. Thank you very much, Mr. Chairman.

Dr. Bowen, I appreciate your testimony. I would like to make a statement first disagreeing with one of your recommendations, and that is to require Medicare coverage for State and local employees who are existing employees.

I am familiar with the arguments why it is just to do that. I am not sure I agree with them. But it seems to me that this is a poor time to be placing a substantially additional tax burden on State and local communities.

In our State of Ohio alone, the public schools will have to pay about $50 million more because of this Medicare coverage. In my State, there are about 600 school districts. Many, many of them will be this year putting property tax levies on the ballot seeking additional funds. And this move that you have recommended can only exacerbate that situation.

Now, I would like to move on and ask you a more general question which you are qualified to answer, both in your current position and as a physician.

I have been contacted in the past by physicians in my district concerned about what they see as a bias in Medicare payments to physicians toward doctors who perform procedures as opposed to those who provide cognitive services. General practitioners and others can spend a lot of time with the patient and perhaps do a lot to make that patient well, but they do not get paid nearly as much as a surgeon who performs a cutting operation.

Have you thought about this in your Department, and do you agree that there is an kind of an imbalance between cognitive services and surgical procedures?

Secretary BOWEN. Yes, that has come up many times in our discussions, as well as in the discussion of the various specialties in medicine. There is obviously disagreement depending upon who you talk to.

We desire to rearrange some of those costs so that the payments to some of the surgical procedures would be put a little bit more in line.

"Inherent reasonableness" was the term that I was trying to come up with. There is difference of opinion as to what the pricing procedure should be in some of the procedures, as well as what the variations should be across the country. For example, for insertion of a pacemaker in one area there might be one price, and in another area of the country, it might be three or four times as much. These are the types of things that we want to get at.

We also have an on-going study at Harvard University on the relative value scales, and that study is to be completed next year. This should have some bearing on the pricing of the various procedures.

Mr. PEASE. So, if I understand you correctly, the only thing that you are doing currently which might narrow the difference between cognitive and surgical procedures is to review and cut back on the reimbursements for some surgical procedures that might be

excessive, but that you have a study at Harvard underway which might give us some hope next year or the year after for a more fundamental readjustment of those relationships, is that correct?

Secretary BOWEN. That is the purpose of the study, yes.

Mr. PEASE. Okay. Let me turn then to another question regarding your catastrophic illness proposal.

As I understand it, your proposal, which is now an administration proposal, does not take into account at all the ability to pay of the Medicare recipient. Is that correct?

Secretary BOWEN. That is correct, yes.

Mr. PEASE. Could you tell us your reasoning in making that recommendation? I am sure it was a considered decision on your part. And also whether there are any figures at all of what it will cost to provide that service for people regardless of their ability to pay? I guess I am concerned because we are going to be raising the part B premium for Medicare recipients in order to generate some revenue.

If we could generate some revenue by picking up part of that catastrophic coverage from people who can afford it, then we would not have to raise the Part B premium so much.

Could you comment on that?

Secretary BOWEN. Yes. We did consider that approach and still say that it is worth discussing. However, we believe that a small increase in the premium for all would make the premium low enough that it would not have the tendency to cause great hardship on anyone.

Many who are at the borderline of the ability to pay even the $4.92 that we have suggested have told me that they would be glad to pay that amount to get the peace of mind from knowledge that they would not be wiped out financially as a result of catastrophic illness.

We set the $2,000 cap at that level because we also felt that that would not have a tendency to pauperize very many people. And if it did, they would be so close already to the Medicaid line, that they could be verging on eligibility anyhow.

It would also be administratively more difficult to handle.

Mr. PEASE. Sure. Thanks very much.

Mr. PICKLE. The Chair recognizes Mr. Gregg for questioning.

Mr. GREGG. I thank the Chairman.

I would like to encourage you, Mr. Secretary, to continue to propose and hopefully pursue the inclusion of State and local employees fully in the Medicare program. After all, the majority of those employees do benefit from it. The rest of the States end up subsidizing those States who do not participate.

I would like to just point out for the gentleman from Ohio's information, that this is a bipartisan effort. I believe the gentleman from California, Mr. Stark, is the sponsor of the bill to require coverage of State and local employees under Medicare.

I was wondering, Dr. Bowen, if you could advise me as to what percentage of the dollar that is spent on welfare gets to the recipient; in other words, the recipient gets how much of every dollar that is raised and allocated to welfare? Does 30 percent of it get to the recipient? Does 40 percent of it get to the recipient? How much

of it goes to overhead, between the Federal and State levels, as it is filtered down?

Secretary BOWEN. I talked with Mr. Hobbs yesterday just on that subject.

In the AFDC program administrative costs are about 10 percent. But in covering all of the programs, there is about $132 billion that is spent on welfare programs each year for about 59 different programs. And if I recall his statement right, it takes about, for all of those, about $2 of cost to get $1 to the individual.

Mr. GREGG. So we are saying that there is only a 33-percent direct benefit to the recipient for every dollar spent?

Secretary BOWEN. That is taking everything into——

Mr. GREGG. Of all the welfare programs?

Secretary BOWEN. Of all the public programs, yes.

Mr. GREGG. I suspect one of the reasons you folks are pushing the money back to the States and having the local communities administer these dollars would be that you think that those overhead costs—which is an outrage and a scandal would be reduced, and we would get more money to the recipient.

Secretary BOWEN. We would get more good out of the dollar spent, yes.

Mr. HELMS. Let me also add that the working group looked at this. We talked to a lot of Governors, and we have received several plans from Governors of ways that they would like to administer public assistance programs under the demonstration authority. They have notions of combining programs and greatly reducing the administrative cost of getting more assistance to the truly needed. We would like to give them the opportunity to go out and try out some of these ideas.

Mr. GREGG. Well, I think that is essential because I do not see how you can go to the taxpayers in this country and ask for more money for welfare when you are really not asking for more money for the welfare recipient, you are asking for more money for the overhead and for the people who are administering that program. When 66 percent of the funds go for administration rather than to the recipients, I think we have to try to correct that imbalance, and I think the direction you are going is correct, to try to return it to the States and the local communities. I suspect they will more efficiently deliver those dollars.

In the area of Medicare part B, which is in the fastest growing cost of Medicare over the last few years, I am wondering what your suggestions are for controlling of part B costs, specifically, for physicians' fees?

Secretary BOWEN. I am not sure I understand your question, sir.

Mr. GREGG. What are your proposals for controlling the increased cost in part B, specifically in the physician fee area?

Secretary BOWEN. One of the recommendations that the administration has put forth is the "RAP program" which would bundle together the Medicare payments to radiologists, pathologists and anesthesiologists. Another would be to limit costs for special procedures, such as cataract surgery; a reduction of 20 percent for the new physicians who joined Medicare and the reason for that is that it avoids the new ones coming on being paid more than those who have been established in the program.

We would reduce the fees that are deemed overpriced, such as a single fee for several services that do not reflect a longer stay in the hospital. A reduction of the services where there is a large disparity of charges between specialties and also between various areas of the country. And then we have suggested repeal of expansions of Medicare reimbursement for optometry, occupational therapy and physicians' assistants services which we think, duplicate services which are already available.

Mr. GREGG. You have listed a series of specific concerns, which I am sure all go to address the problem.

Do you have a conceptual approach on the whole issue of controlling part B costs that you are thinking of moving toward, or are you going to just sort of take it bit by bit, the way you are?

Mr. BURKE. Congressman, I think one of the thrusts of the administration has been to advance the private health plan option. With part B, you are looking at 75 percent of your costs going up for physician services. We do not have any system in place now, such as prospective payment for part A, which is going to hold down either the price or use of these services. Congress in the past has resorted to successive freezes on physician services. Even that, however, does not control the utilization of physician services.

The answer down the road seems to be a managed care concept, which is conducive to a capitated approach to providing health care. And this is one of the initiatives this administration is proposing.

Mr. GREGG. I guess my time is up.

Thank you.

Mr. PICKLE. Mr. Secretary, at this point, I want to ask you a question about the disability program under the Social Security Administration.

As you know, the Congress has been seriously concerned about the establishing of fair and efficient review and administration of the Social Security disability program. It has been a controversial subject.

Your predecessor some 3 years ago chose to suspend any systematic review because it was such a controversial issue. That was one of the reasons we stepped in, and we passed a 1984 Social Security disability bill which the administration finally endorsed.

Now, after 3 years, we still have not set up any kind of meaningful, substantial review of the Social Security program, the disability program.

My question to you is what is the intent of the administration? Are you going to set up any kind of a meaningful review of the disability program?

Secretary BOWEN. I guess I am taken a little by surprise. I thought that we already were doing that and it was working quite well on the disability review.

The statutory mandate of the Disability Advisory Council is to study the effectiveness of vocational rehabilitation programs for Social Security disability insurance and supplemental security income beneficiaries, and the use of work evaluations and vocational and medical specialists in the disability decision process. We are doing those things.

Mr. PICKLE. Well, now, Dr. Bowen, you are cutting the staff level of the Social Security Administration throughout all the agencies. You are not getting any extra help for the disability.

I am sure the chairman of the Social Security Subcommittee may ask you some questions about staffing level.

But most of us, numerous members have heard from our State agencies complaining that the personnel are being cut. Their staffing has been reduced.

Are you familiar with the fact that we wrote a letter to Commissioner Dorcas Hardy objecting and complaining and raising the questions about the administration of the disability program, are you familiar with that letter?

Secretary BOWEN. I am not familiar with that letter.

Mr. PICKLE. Well, Secretary Bowen, I am going to ask the staff to hand deliver you a letter right now that Chairman Rostenkowski jointly signed with Mr. Jacobs and me, strenuously objecting to the fact that you are not properly administering the disability program. We sent that to Commissioner Dorcas Hardy 3 weeks ago.

We have not received a phone call or anything indicating that that letter has been received. The complaints are streaming in from all over the country.

Now we passed a good disability bill in 1984. That is not being carried out, and it is either being constrained at the Social Security level, or it is being mandated for choking by the OMB. I do not know which one it is.

Are you familiar with the staffing level of the disability program and the fact that we are not adequately reviewing these cases?

Secretary BOWEN. The information that I have is that we are not cutting back on the DDS staffing levels necessary to handle the projected DDS workloads. Some DDSs were staffed in the fiscal year 1986 at levels higher than projected workloads would justify, so to achieve a more equitable distribution of these DDS resources nationally, these DDSs are reducing staff but doing it just through attrition until the imbalances in the staffing levels are minimized.

There should be no increase in the DDS case processing times, because we have established a minimum productivity expectation of 195 cases per work year, and that is an increase over fiscal year of 1986.

So this productivity goal should be met by the DDSs without any difficulty.

Mr. PICKLE. Well, Secretary Bowen, I suggest that you listen to some of your State agencies and get a further report. They are complaining to us, the Members of Congress, that they are understaffed, that they cannot properly administer this program, that they are not being reviewed.

The situation may be not only cruel but almost scandalous, the way that we are refusing to give any attention to the disability program. Now it was the intent of Congress to do something about this program. We passed a good bill. I submit to you it is not being properly administered, and I hope that you personally will look into this.

When the Chairman of the Ways and Means Committee addresses a serious question to the Commissioner of Social Security, and 3 weeks later we have not even got a phone call acknowledging it, I

say to you there is an effort to stonewall the proper administration of this program. So I ask that you personally look into this aspect of the Social Security Program.

Secretary BOWEN. I shall. Thank you.

Mr. PICKLE. Thank you. Now the Chair would recognize Mr. Jacobs for further questioning if he would like to, at this point.

Mr. JACOBS. Doc, I am sorry, I had to step out for a few minutes. Have you been asked about the 4,000 reduction in the Social Security staffing yet by any member?

Secretary BOWEN. No, I have not.

Mr. JACOBS. The question simply is this. With the GAO report—the modernization technology, the computers and so on, not quite up to speed as anticipated at this point, do you think 4,000 is a realistic figure?

Secretary BOWEN. Congressman, I can only say that we certainly do not intend to reduce the staffing levels at the expense of the service to the beneficiaries. We are moving cautiously with employment reductions through attrition, and still trying to maintain the tradition of the Social Security's quality of service.

In fact, I think the survey last year by GAO stated that three out of four of the Social Security recipients who were interviewed stated that they were very pleased with the service that they were receiving and that is a pretty good percentage.

The additional savings budgeted for 1987 and 1988 will be achieved again through planned management, through procedural and systems improvements, and from continued improvement in the productivity of the Social Security Administration employees.

Mr. JACOBS. Thank you.

This is a little bit off the wall, and I would not be surprised if you are not conversant with it—just disregard the question and we can talk about it later.

For a couple of Congresses I have had a bill in to eliminate the immunity of Federal employees from garnishment proceedings.

I am specifically interested in whether you have a view at the moment about that proposal with regard to support payments, delinquent support payments, perhaps, as obligations of Federal employees. If you would rather withhold that and get an answer back in writing, I can understand; it is a little off the wall.

Secretary BOWEN. I am not prepared to answer it now.

Mr. JACOBS. Yes. If you can look into it and maybe just shoot up an addition to the record at the appropriate time, I would be grateful about that.

Secretary BOWEN. Okay.

Mr. JACOBS. I think the origin of the immunity is to solve an immunity generally, and I don't think it was ever contemplated to shield a large segment of the American population from normal court procedures, if any part of that population should prove to be, shall we say, deadbeats.

Finally, have you an opinion about the proposed independent agency for the Social Security Administration? I would find it hard to believe you did not.

Secretary BOWEN. I find it difficult to disagree with you on this one, Congressman. I oppose the separation of the SSA from the Department. I think our opposition has rested primarily on the

grounds that making SSA independent would undercut the advantages of having interrelated agencies within the same department under the same departmental leadership.

Establishing SSA as an independent agency governed by a bipartisan board, or a different way, would, I think eliminate the Agency's Cabinet-level representation, and I think the 30 million people out there receiving Social Security benefits should be represented by a Cabinet member.

I think it would break up the integrated system of service delivery for income maintenance, for family services, and health programs. It would require expenditures of some of the Social Security trust funds for duplicative and expensive payroll personnel and other support structures now operating, I think, fairly efficiently at HHS.

In my judgment, the independent agency status just cannot insulate Social Security from political pressures. The same groups of elected officials will continue to play roles in the development of the Social Security policies, and I do not think that is all bad.

I do not think it would even be desirable to insulate the agency which makes decisions affecting millions of people, and manages billions of trust fund dollars from external influences.

Because it is such a large and critical program, Social Security should be accountable, I think, to the official that is elected by all the people, the President. I have many statements as to the improvements that have been made, and the length of time waiting, and the length of time to get your Social Security card, and so forth. The implication is, "if it ain't broke, don't fix it," and I am not sure that it is broke.

Mr. JACOBS. Doc, I assume that if the Congress took any action, you probably would prefer the House version to the Senate version of the previous Congress, which as I recall proposed the independence of the Medicare system from HCFA as well as the independence of the SS for the old age of survivors and DI as an independent agency.

If this terrible thing befell you, you would probably prefer the House version, would you not?

Secretary BOWEN. I suspect so. I have not studied or compared them that closely.

Mr. JACOBS. I do not think there is much chance that it would not pass. I think it just passed unanimously, did it not, last year, but now that I am the principal sponsor, I probably can figure some way to—I will not finish that sentence. Thank you, very much.

Secretary BOWEN. Thank you.

Mr. PICKLE. Dr. Bowen, I want to pursue this line of questioning because we are on this subject. My concern is that—I am taking my own case in Austin, TX, with respect to Social Security as a kind of a measurement. In the Austin area, the Social Security staffing has been cut by 14 percent, and our overtime has been cut from about 500 hours per month down to zero.

At the same time, the number of cases has steadily risen, increased. Is this representative of the cuts throughout the system?

Secretary BOWEN. I do not know what the——

Mr. PICKLE. As I understand your budget, you are going to actually cut about 17,000 positions in the next 5 years from the Social Security program—not just disability, but the Social Security program. Is that essentially correct, or can your staff verify that? As I understand it, it would be those kind of cuts in personnel, is that right?

Secretary BOWEN. I think over the next 5 years, that is right.

Mr. PICKLE. That means that we can expect further personnel cuts in 1988 on a regular basis.

Secretary BOWEN. By attrition, yes.

Mr. PICKLE. Then how do you justify cutting back seriously the services to people at a time when the system is very economically sound? Do you have funds for those purposes?

How do you justify cutting back the services when they are so desperately needed by the States, as the States will testify?

Secretary BOWEN. We have had great increased efficiency in the total operation. There has been more automation done. And there has been a need to—

Mr. PICKLE. Dr. Bowen, you do not have your computers in place over there. There is some automation but your computerization is not in place for all these personnel cuts, you may anticipate that, but it is not in place now. But you have already ordered the cuts before the computerization has been set up.

Secretary BOWEN. We are not ever going to sacrifice service. In the event we find there is need for more, we will not be bashful in asking. But I can cite the fact that 42 million Social Security checks go out every month with almost an accuracy of 100 percent.

Mr. PICKLE. A very enviable and commendable record. It is unbelievable what they do about issuing the checks.

Secretary BOWEN. The claims time for processing is down, now, to less than 21 days, and that is the lowest in history. The public and the GAO survey just last year, in 1986, says that three out of four of the Social Security recipients say that they are satisfied with the service. The waiting time within the offices is cut down, I think, from 12 minutes to 9 minutes. We have a lot of telephone answering services that are being done that require a lot less time than coming into the office and——

Mr. PICKLE. I am certainly not critical of the Social Security program. I am not chairman of that committee. But you have established a very enviable record.

I am concerned about the services that you ought to be rendering now and in the future. When you say that you are going to make 17,000 cuts in the next 5 years just because the program will be automated and people will be more efficient. It just seems to me that is just a statement of bravado to cover up the fact that the services are needed. There will be an increase in demand, and, at a time when you have ample funding, it seems to me that you are letting OBM control what you think ought to be done.

At least that is the way I feel about it. I think that is something that we have to address, maybe in a special oversight hearing later, if it is granted.

I thank you, doctor.

Now Chair recognizes—I believe Mr. Chandler is the next. Mr. Chandler.

Mr. CHANDLER. I would like to yield my time, Mr. Chairman.

Mr. PICKLE. All right. Mr. Daub.

Mr. DAUB. Mr. Chairman, thank you very much.

When you consider that we eventually will have 54 million Americans over 65—we soon may see that point where the baby bust matures, about 1993 or 1994, into a labor-short economy for the first time.

We are talking about catastrophic health insurance to take up the needs of the elderly because we recognize that, Mr. Chairman. Yet we fail to understand that even government is going to have to become more efficient because that labor shortage is going to effect how we staff all of our offices, including the Social Security Administration.

So I do think that over a period of years, a 5-year period with the very, very fine computer systems that I understand we will get to see next week, unveiled, that this attrition process of 3,000 or 4,000 thousand people over time might work very well.

I want to say that they consolidated the offices in Nebraska; that the morale is higher than it ever has been, and the efficient delivery of services by the Social Security Administration is working very well as a result of that consolidation. Using attrition to reduce staffing levels means you do not unjustly treat current employees, and yet with fewer numbers and automation, you can continue to give efficient and high quality personal service when needed.

So on that point I must say, at least in my experience, the plan is going very well, and I certainly think that Dorcas Hardy is doing a good job, and you are to be commended in her choice, as well as that of Dr. Roper at HCFA. These are tough times, and personnel changes are going to take place over the next 6 years. We had better be prepared for them, and not just find out that we are in this stark cliff of a shortage of people to replace people whose jobs become vacant by retirement.

So I think we are headed in the right direction, and I can tell by your comments, Mr. Secretary, that you are going to be cautious and not just use automatic goals of 17,000 in a cold way to reach your quota or your goal. So I appreciate that.

Let me say that Mr. Gregg asked a good question. Mr. Secretary, would you please furnish us with Mr. Hobbs' information, or yours, if you have it, on this proportion of overhead? I think that would be useful to the committee. We would like to have that if you could give it to us.

Secretary BOWEN. All right.

[The following was subsequently received:]

RESPONSE OF SECRETARY BOWEN

In response to your question and those of Mr. Gregg, I will clarify; as I said, the AFDC program, which many people think of when they think of welfare, has administrative costs of a little less than 10 percent of all expenditures. This range is typical of many public assistance programs. AFDC is an entitlement program which matches appropriate state expenditures without any cap on Federal matching funds. Other public assistance programs have capped appropriations each year, and many have earmarks of a certain percentage of all Federal funds which may be used for administrative expenditures by the grantees. These caps vary somewhat, but generally stay in the range of 5 to 15 percent.

As part of its study of low income problems, the Low Income Opportunity Working Group requested information from administering agencies about all 59 of the

major means-tested programs listed in the report "Up From Dependency." Among the information requested was the portion of all grantee funds used for administration. At this time, we are still reviewing the detailed information received with the intent to publish a compendium of information on all 59. While we do not have an exact figure to provide for the combined administrative expenditures of all 59, it is clear that the final estimate will be consistent with the general description above.

It also should be noted that definitions of administrative costs, as practically everything else about the system of welfare programs, varies considerably from program to program. Indeed, with some programs, the very distinction between the cost of administering the program and the costs associated with benefits or services to recipients can be difficult to draw. This is especially the case with some service programs which provide no cash or material benefit directly to recipients.

Another issue which the report to the President addressed, and which appears to have been the point of part of the response to Mr. Gregg's question, is "How much of the $132 billion spent in fiscal year 1985 by the 59 major Federal means-tested programs actually went to those classified officially as poor?" What the report stated, based on an analysis of survey data supplied by the Bureau of the Census, is that for every two dollars of welfare benefits reported, only a little more than one dollar raised peoples' incomes up toward the poverty line. Only about 55 percent of the cash and non-cash benfits for food, housing and medical insurance captured in the Survey of Income and Program Participation was found to reduce poverty. The other 45 percent was received by families after welfare benefits had already raised their incomes above poverty, or whose income was above poverty even before any welfare benefits were received. This is not an issue of administrative costs or overhead, but an issue of target efficiency for welfare programs considered as a system.

Mr. DAUB. If AFDC is 10 percent and the overall load is 66 percent, that means some of the public assistance programs we are talking about have inefficiencies of 80-percent cost and we are only delivering 20 percent to the intended beneficiaries. I would certainly appreciate studying that a little more and——

Mr. HELMS. Mr. Congressman, that is not quite correct, but let me say that we will be glad to supply you with those figures.

Mr. DAUB. Let us just have the information, anyway. Good.

I think Mr. Pease was very accurate in raising his comment about cognitive services and reimbursement for them, which leads me to ask this first question about physicians' DRGs—that is radiologists, anesthesiologists, and pathologists being included in a DRG-type situation. This proposal does not save much money. What is the reasoning of the Department and the administration behind that recommendation in the budget?

Secretary BOWEN. There are a couple of reasons. Even though it doesn't save much, we have to reach a bottom line, and it does assist on that. As you know, this proposal was never our first choice, but there is some good reasoning behind it: the physicians in the RAP proposal are hospital-based; so they do function differently from the rest of the physicians.

Our proposal is simply to bundle the payment for the radiology, anesthesiology and pathology services provided by physicians to hospital inpatients into a fixed payment. The details are not all worked out. We are working on them, and probably will be for some time yet. But the questions are: whether to pay the hospital or the physician group; how you treat assignment and balanced billing; what the appropriate future update factors should be; whether there should be possible adjustments for geographic location because there are differences in pricing; and whether the payment for the RAP services should be folded into the hospital DRGs, or whether they should be made separately.

These are the things which we still have to study, and the decisions are not final on them.

Mr. DAUB. I appreciate the degree of care you are giving because I know that since we started out a long time ago with the DRG base, we have seen a built-in disparity of the reimbursement under the DRG.

It really is going to work a hardship, not that these are categories that ought not to be looked at, but it is going to create even further disparity by region, I am afraid. And so I would appreciate a very careful look, Mr. Secretary.

I have one quick question. I would yield very quickly, if I could, to my friend from Ohio.

Mr. PEASE. I appreciate the gentleman yielding. I hate to take up his time.

Is it not true, Dr. Bowen, in the case of radiologists and anesthesiologists, that there is currently a study under way right now, the report of which is not due in until sometime this summer; and that Congress specifically envisions waiting until after that report comes in before deciding whether or not to put those folks under DRGs?

Secretary BOWEN. That study is, I believe, almost complete.

Mr. DAUB. Yes, it is coming, I think.

I appreciate the gentleman's information.

One other question, Mr. Secretary. We are proposing a part B premium increase of 35 percent for new beneficiaries, leaving the old beneficiary at a lower rate. Therefore, we would start out to have a two-tier voluntary payment of premium.

Do you see that causing any problem with the catastrophic premium and its additional cost? Are we getting into an inconsistent approach to the way we ask a beneficiary to pay for this whole part B premium?

On the one hand we have got two tiers recommended, and on the other hand we are going to add a new cost to it, and then to two tiers, I take it?

Secretary BOWEN. I do not think it would make any difference on the catastrophic end of it.

The theory behind this is that the original plan, of course, was to have the Federal Government pay 50 percent and the individual 50 percent. Now that has changed so the Federal Government is covering 75 percent and the individual 25 percent.

Mr. DAUB. Thank you, Mr. Secretary.

Mr. Chairman, I have two unanimous consent requests, if I might, from my colleagues.

For Mr. Crane, who was unable to attend, would like to be able to submit questions in writing to Secretary Bowen for response as part of the record.

And a second request, that on behalf of Mr. Gradison and others on this side of the aisle, we have three questions that we would like to submit, that responses from the Secretary as well could be made a part of the record.

Mr. PICKLE. Without objection.

Mr. DAUB. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

[The following was subsequently received:]

RESPONSE OF SECRETARY BOWEN TO QUESTIONS POSED BY REPRESENTATIVE CRANE

*Question.* Mr. Secretary, before I begin with my questions, I would like to thank the Administration for including in its proposal a Treasury study of the feasibility of an alternative program of health care savings accounts used to buy basic post-retirement health insurance. Having introduced the "Health Care Savings Account Act of 1987" with my colleagues Congressman French Slaughter and Congressman David Dreier, I want to express our willingness to include a Health Care Savings Account provision as the long-term care component of the Committee-reported bill.

My first question is in regard to the President's initiative on acute catastrophic care for the elderly. I praise the President for making an important first step in the search for a constructive solution to the problem of catastrophic medical expenses faced by the elderly. I would encourage the Administration actively to seek to guarantee that the catastrophic care proposal crafted by the Congress ask only for voluntary participation and that the propram be self-funded by the program's participants. I feel very strongly that these two requirements will act as a check against unwanted government involvement in the private lives and decisions of the American citizens. Will the Administration insist upon these two criteria?

Answer. First of all, Mr. Crane, let me commend you and your colleagues, Representatives Slaughter and Dreier, for your proposal, which is something this Administration is actively reviewing. As you know, on February 12, 1987, the President announced that he was directing the Treasury Department to study encouraging personal savings for long-term care through a tax favored individual medical account (IMA) combined with insurance, and amending individual retirement account (IRA) provisions to permit tax-advantaged withdrawal of funds for long-term care expenses. That study is now on-going.

With respect to your question, the Administration believes that any catastrophic legislation which is enacted should be self-financing and budget neutral. The President's bill incorporates the voluntary concept, since it builds upon the current Medicare part B program, which is voluntary.

*Question.* Would the Administration support a funding mechansim for a catastrophic care plan which increases the taxes paid by the elderly?

Answer. On many occasions, the President has stated his vigorous opposition to tax increases.

*Question.* Would the Administration support a funding mechansim which would increase the taxes paid by any group of individuals who would not be current participants in the plan?

Answer. As I stated in my previous response, the Administration is opposed to tax increases.

*Question.* I am quite concerned with the financial stability of the Health Insurance Trust Funds. In their 1986 report, the trustees of the Medicare (HI) Trust Funds, predicted that, under one set of assumptions, the trust funds would no longer be able to pay benefits in less than a decade. While I applaud the effort to find a solution to the castastrophic coverage problems, I urge the Committee to consider carefully the potential effect on the financial solvency of the Medicare trust funds which might be caused by an expansion of the Medicare benefits to include catastrophic coverage. Would the Administration provide the Committee with the Administration's criteria that will be used to ensure that the legislation reported out by this Committee meets the President's guideline for his own bill that "the proposal must be fully budget-neutral, without the explosive potential of program expansion."

One of the other guidelines for the President's proposal on acute care Catastrophic Illness Insurance for the elderly is that "the importance of Medicare, Medicaid, and Medigap should be maintained and we should not encourage excessive use of service." Would the Secretary please submit for the record the studies HHS used during the preparation of its report to the President which showed how each of the options it considered affected the private insurance market?

Answer. Representative, we were fully cognizant of the important role that the private insurance market plays in every step of our deliberations on the catastrophic health care issue. We believe that a substantial role for private insurors would be available should the President's bill be enacted. I would be glad to make available to you the reports of our technical work groups—these reports comprise some 1600 pages of information and show the extent to which we factored in the private insurance market in our deliberations on the issue.

*Question.* Would the Secretary also sumit his Department's estimate of how many individuals will receive benefits for hospital expenses should the acute catastrophic

bill being introduced tomorrow by the distinguished chairman of the Health Subcommittee be enacted into law?

Answer. We have estimated that the President's bill would aid about three percent of the Medicare population—about 31 million individuals receive Medicare benefits. In contrast, we believe that the bill being contemplated by the Chairman would provide benefits to about eight percent of beneficiaries.

*Question.* Would the Secretary also provide HHS's estimate of how the Health Subcommittee Chairman's bill will affect the size of the private insurance market over the next five years, both in terms of aggregate dollar size of the market and employment in that market?

Answer. The Department does not have available any information which projects the effect of the Stark/Gradison catastrophic legislation on the private insurance market.

RESPONSES OF SECRETARY BOWEN TO QUESTIONS POSED BY MR. GRADISON

*Question.* Dr. Bowen, Mr. Stark and I have been working with the other members of the Ways and Means Committee Health Subcommittee to draft a medicare catastrophic bill. We appreciate the leadership you and the President have offered on this issue. To fund our proposal, we have chosen to recommend a tax on the actuarial value of a portion of the Part A and Part B benefit. This proposal would keep our medicare catastrophic proposal budget neutral and fund it by payments from those beneficiaries who can most afford it.

What is your reaction to this means of funding medicare catastrophic? Do you have any suggestions on alternative ways to "income" relate the funding for medicare catastrophic?

Answer. At the outset, Mr. Gradison, let me commend you, too, for your great leadership in promoting the idea of catastrophic health insurance for the elderly. Our progress to date rests in large part on your significant efforts. The Administration has opposed the tax on the actuarial value as embodied in H.R. 1240, the catastrophic legislation you and Chairman Stark have authored. Instead, we continue to believe that the President's approach, which spreads a modest premium across all beneficiaries, is more fair and equitable. I am not opposed to considering income relating, but do not believe that a catastrophic bill is the appropriate place in which to introduce the concept, not do I have any alternatives to share with you.

*Question.* Dr. Bowen, last year in OBRA, the Congress required the Department of Health and Human Services to begin peer review of medicare HMOs by April 1, 1987.

Will you make that deadline? Could you outlined for the Committee the issues yet unresolved between the Department and the Office of Management and Budget over PRO review of HMOs and the implications of this controversy for the implementation of this congressionally mandated review program?

Answer. We expect that monitoring the quality of care by HMOs will begin April 1, and there are no issues outstanding at this point which could hold up that timetable. As you may be aware, in some States we plan for the review to be conducted by PROs, and in other States both PROs and other organizations will compete for review contracts. As you may also be aware, HCFA published in the January 5 *Federal Register* a tentative list of 25 States where the contract will be awarded competitively. Comments on that list are now being reviewed.

*Question.* Dr. Bowen, last year many of my colleagues and I became alarmed when we learned that the Administration was encouraging its contractors to slow down payments for medicare claims. The Omnibus Budget Reconciliation Act (OBRA) included provisions to assure that medicare claims would be paid in a timely manner. Congressional intent under OBRA clearly assumed that payment would be made according to historical patterns. The measure specified that claims be paid in "no more than 30 days" because at the time we were led to believe that 30 days was the standard for 1987.

Recently, the Health Care Financing Administration took a narrow view of this 30-day standard and was going to slow payments now made in less than 30 days to that standard. Mr. Stark, the Chairman of the Health Subcommittee, and I complained to you, Mr. Secretary, and the proposal was dropped. However, we learned during the debate over this proposal that current standards for payments are frequently much lower than 30 days. This is the case in my home State.

Under the current budget proposal, it appears that the Administration wishes to disregard historical payment patterns and pay on the last day or just before the law allows. In addition, this proposal results in no permanent budget savings—it merely shifts the timing of payments while causing hardship on providers and beneficiaries.

Dr. Bowen, how do you justify this position in light of congressional intent? How do you justify reimbursing beneficiaries more slowly? How do you justify paying physicians more slowly when medicare is trying to encourage them to join the participating physicians program? And, finally, as medicare drops periodic interim payment for most hospitals, how do you justify slowing payments to these institutions when they are about to feel the cash flow "shock" of losing their level biweekly payments?

Answer. Our proposal to extend indefinitely the FY 1987 claims payment policy articulated in OBRA 86 of paying 95% of clean claims within 30 days is consistent with commonly accepted business practice. We feel that adopting this claims payment approach is a prudent policy for achieving deficit reduction targets and does not jeopardize the service levels provided by any of the Department's programs.

We project at this point in February that by the end of the fiscal year all clean Medicare claims will have been paid within an average of 20 days. Actual payment rates will vary to some degree by bill type (for example, electronic versus paper claims).

With respect to the effect on providers, especially those in financially-pressed institutions, we note that all businesses must deal with changes in cash flow. There are a number of options providers can use to respond to this:

Bill faster: we estimate that hospitals on average take more than a month to send their bills to Medicare.

Pay slower.

Draw on working capital.

Develop lines of credit with financial institutions.

Mr. PICKLE. Now the Chair recognizes Mrs. Kennelly.

Mrs. KENNELLY. Thank you, Mr. Chairman. Thank you, Mr. Secretary, for your testimony.

Mr. Secretary, I know you have been following, as we have, the progress in welfare reform. Of course, yesterday and the day before, the Governors with their meetings with the White House, we made some progress with all of us in that the President agreed to the contractual arrangement that there would be a trading of services with the State, and with the Federal Government, working together, which is a plus.

There is another piece of welfare reform which is just absolutely necessary if we are going to have welfare reform to use. That is child support enforcement. I worked on this committee in a bipartisan fashion, and with HHS to improve the 1984 collection of child support.

And yet I see in your two major child support proposals, in page 7 of your remarks, two directions—the first one of which, of course, I agree with. But recently, in Connecticut, I have had a problem—and by the way, we used Connecticut in our child support work, as a State that did do quite a bit. We have a grant in Connecticut, which was given a grant by HHS, that allowed us to do a demonstration program on interstate collections. Now that is one nut we have not been able to crack as far as child support, is the problem with interstate when the parent goes across the state line.

We have been notified in Connecticut that because we had done so well in the first year of the demonstration program, our funds would be cut for the second year because we did not need them. We could be on our own.

Now you are a former Governor. You know what happens if you do not get that second year funding. You waste the first year funding because what has been done is wasted. You are not going to go do it on your own.

If, in fact, you have been told that you have 2-year funding, I hope that does not mean modifying—your No. 2 point—modifying

the Federal financing of the child support program isn't going to be this type of modification. Could you help me along on that?

Mr. HELMS. I understand that the interstate child support grants were originally intended as a demonstration to get States started in an activity. It was never intended to be an ongoing type of funding.

Mrs. KENNELLY. Oh, no. This was a 2-year demonstration program. We did the first year, and then we were told because we were doing well—the funds were rescinded is what happened.

Then we heard there were surplus funds, and in fact, the surplus funds were going to be used in other States—such as California, other New England States, New York—which had not started their demo programs. In fact, we had letters of agreement with these very States for interstate contractual agreements, which is what we have to have to make child support work.

I am just bringing it to the Secretary's attention. Sometimes all of us get carried away in our desires to cut. You know, we are all looking for funds to cut back the deficit, but if we have got something that works, it would be awful to modify Federal financing of child support when we need it for welfare reform. We cannot do child support if we cannot do something about interstate collections. So I just would bring that to your attention.

Now, Dr. Bowen, one of the things that makes me hesitate about welfare reform and makes me worry about promising too much is the fact that so many of the people on welfare are single women with children. And the work program, which we are all agreeing upon is the strong piece in welfare reform, raises the question of what we do about day care.

You mentioned that you, the administration and your proposal is looking at day care for having mothers work, because we are in agreement on this, having mother work when they have children 6 months.

Now, the proposal I am about to put in today has a 3-year cutoff for parents. Could you have somebody in your Department send me how you are going to do 6 months, or how you can even approach this, when I am having such trouble thinking about three years when we have lack of day care as we do across this country?

Secretary BOWEN. Our program includes a 50 percent Federal match for day care and also transportation. That is part of the GROW program, so I think it would answer that question.

Mrs. KENNELLY. Well, we are going to have to really flesh this out because just the licensing, the backup, the support services for a 6-month-old child in a day care establishment are expensive and they are important.

We do not have much day care in this country. We certainly do not have anything near what we should have, and I think we are all going to have to work together on this piece; otherwise, we are fooling ourselves that we are going to have welfare reform.

Maybe we could try to work together to see how we do this.

Secretary BOWEN. I think that we should work together on that, and we would be glad to do that.

Mrs. KENNELLY. Thank you, Dr. Bowen.

Mr. Chairman, I have a series of questions concerning title IV–E foster care and adoption assistance, and they are fairly technical. I

am going to submit them, if the chairman will allow me, for the record.

What I am talking about is your budget assumes passages of legislative proposals that limit State administration and training costs on these programs. And you go on to say that there has been almost a 500-percent increase in the last 4 years in 16 States concerning administrative costs, which I would admit would be shocking.

I think we have got some problems about how you define administrative costs. Is it possible this could be counseling or something that does, in fact, get to the client? I am going to submit these questions so you can help us figure out exactly where we are going along this line, because I agree with you. Mr. Gregg mentioned his concerns; if it is a 500-percent increase in administrative costs, something should be done, or is it the way things are being reported. So I am going to submit these questions, Dr. Bowen.

[Responses of Secretary Bowen to questions posed by Mrs. Kennelly follow:]

QUESTIONS BY MRS. KENNELLY

1. Your budget assumes the passage of a legislative proposal that will limit State administrative and training costs in the Title IV-E foster care and adoption assistance programs to 50% of the amount reimbursed to States for maintenance costs. According to your budget briefing materials, you feel this is necessary because administrative and training costs have increased 500% in the last four years and in sixteen States, more than 1000% since 1981.

1.(a) Question: Do you have any thoughts/opinions as to why these increases have occurred?

1.(a) Answer: We believe that, generally, the dramatic increase in claims under Title IV-E has resulted from exploiting the open-ended Federal reimbursement, rather than from the provision of additional services to children. There is no evidence to show either that added protections or added services are being provided to foster children or their families in those States where claims for administrative costs are high.

1.(b) For the record, could you provide some information which would help the Committee to understand the reasons for such increases. Specifically,

Question: - with regard to the increases noted in your briefing materials, would you separate out how much is attributed to the foster care program and how much to the adoption assistance program.

Answer: Claims for Title IV-E foster care administrative costs have risen from $30 million in fiscal year 1981 to nearly $156 million in fiscal year 1985. Claims for Title IV-E adoption assistance administrative costs have risen from $.055 million ($55 thousand) in fiscal year 1981 to nearly $7.7 million in fiscal year 1985. The large increases that we have noted in certain States all occurred in the foster care program.

Question: - could you provide a list of activities for which States claim administrative and training reimbursement in both the foster care and adoption assistance program.

Answer: Title IV-E (section 474(a)(3)(B)) permits States with approved Title IV-E plans to be reimbursed at a 50% matching rate for the costs of administrative activities as found necessary by the Secretary for the proper and efficient administration of the State plan. 45 CFR 1356.60(c) implements this section.

Foster Care: For the foster care program, certain administrative costs, listed in section 1356.60 (c)(1), may not be claimed under any other section of Federal regulations or any other Federal program. They are:

1 -- the determination and redetermination of eligibility

2 -- fair hearings and appeals

3 -- rate setting

4 -- other costs directly related only to the administration of the foster care program.

Section 1356.60(c)(2) lists examples of other allowable administrative costs necessary for the administration of the foster care program. They are:

1 -- referral to services

2 -- preparation for and participation in judicial determinations

3 -- placement of the child

4 -- development of the case plan

5 -- case reviews

6 -- case management and supervision

7 -- recruitment and licensing of foster homes and institutions

8 -- rate setting

9 -- a proportionate share of related agency overhead.

Adoption Assistance: Similar costs may be claimed under the adoption assistance program. Costs that may be claimed only under Title IV-E include:

1 -- the determination and redetermination of eligibility

2 -- fair hearings and appeals

3 -- rate setting

4 -- other costs directly related only to the administration of the adoption assistance program

5 -- grievance procedures

6 -- negotiation and review of adoption agreements

7 -- post-placement management of subsidy payments.

Examples of other allowable administrative costs considered necessary for the administration of the adoption assistance program include:

1 -- referral to services

2 -- placement of the child in the adoptive home

3 -- development of the case plan

4 -- case reviews conducted during a specific preadoptive placement for children who are legally free for adoption

5 -- case management and supervision prior to an interlocutory or final decree of adoption

6 -- recruitment of adoptive homes

7 -- home studies

8 -- proportionate share of the development and use of adoption exchanges

9 -- a proportionate share of related agency overhead.

Training: 45 CFR 1356.60(b) specifies that training costs may be matched at the 75% rate, that all training activities and costs claimed under Title IV-E must be included in the State agency's training plan for Title IV-B (child welfare services), and that short and long term training may be provided and claimed only under specified conditions.

Question: - for each of the activities listed, could you state what proportion or percentage such activities make-up of the total administrative or training costs, for each of these programs.

Answer: We do not have a break out of the costs of these separate activities.

Question: - could you compare the specific activities claimed in FY 86 as related to 1980, 1981, 1982, 1983, 1984 and 1985, by percentages.

Answer: We do not have a break out of the costs of these separate activities for any fiscal year.

2. Question: What is the status of your reprogramming requests with regard to both the Title IV-E Independent Living Program and Title IV-B Child Welfare Services Program.

Answer: The Department has sent a letter requesting reprogramming to the Congress and is awaiting approval of that request.

2.(a) Question: If Congress disapproves the reprogramming request for the Title IV-E Independent Living Program, how long will it take the Department to review the states' plans and make the funds available.

2.(a) Answer: States have been notified they have 90 days to submit plans, which are due May 11, 1987. Plans will be reviewed as they are received. States generally may receive funding within 45 days if the plan meets all requirements. If Congress disapproves the reprogramming and repeal request, grants could be awarded within 45 days of our receipt of the Congressional decision and apportionment of funds.

2.(b) Question: Do you intend to review the states's plans as they come in to the Department and make the funds available as soon as possible?

2.(b) Answer: Yes, we will review the plans as they come into the Department and make the funds available subject to a decision from Congress regarding the requests for repeal of the program and reprogramming of the funds.

Submitted by: Otis R. Bowen, M.D.
Secretary
Department of Health and Human Services

Mrs. KENNELLY. And I thank you, and I commend you for your excellent work.

Secretary BOWEN. Thank you.

Mr. BURKE. Congresswoman, on the administrative costs, I think one thing that needs to be pointed out is that we did look across States at the wide variations in administrative costs vis-a-vis the placement rates, the adoption rates. We could find no relationship.

Mrs. KENNELLY. No relationship?

Mr. BURKE. None. States with high administrative costs, they are not inversely related. It is a spurious relationship, as best we can tell.

We ran two different analyses of the data figuring that if we put more into administrative costs we would increase the placements, for example. Not true. It just does not hold.

Mrs. KENNELLY. The whole area is so difficult. If you can help us with answering the questions, we can be coming at it with the same information.

Thank you, Mr. Burke.

Mr. PICKLE. Mr. Ford.

Mr. FORD. Thank you very much, Mr. Chairman. I join with my colleagues, Dr. Bowen, in welcoming you to the committee. I would like to say that I would like to applaud you for your leadership in the catastrophic health care plan as well as those initiatives that you have been able to be in the forefront on as it relates to human services.

Dr. Bowen, I think that several of my colleagues have already talked about the Governors' Association and them fashioning their welfare reform package and focusing in on work, education and training.

You have indicated, I think, in a response to Mr. Gradison earlier that the administration has embraced the Governors' Association's welfare reform package, that component of the package, but embraced it without any additional revenue to pay for the program.

Explain to me, Dr. Bowen, how can the administration embrace that proposal and in the same breath say no to any revenue that it might take in order to finance the program.

Secretary BOWEN. I think the President has also stated that the amount of Federal money that goes into the welfare programs should continue to flow in, and the States know best what their needs are and the States are going to have to assume considerable responsibility on their own as far as some of the additional programs that they might want to put in.

Mr. FORD. Well, now, you talked about 59 programs that you are not certain on the dollar amount that is passed on to the recipients. But in AFDC you responded to one of my colleagues, and you made it clear that 90 percent of all of the AFDC funds passed through to the recipients.

Now, if we are talking about 59 programs that we are not certain administrative costs versus those dollars that are passed on to those that we are trying to help, it looks strange that we would try to consolidate or to eliminate some of the programs that we know are not passing on through to the recipients.

Secretary BOWEN. Well, some of that money that is used on the less effective ones or those that are less cost effective certainly could be reapplied to the areas that you are talking about. The total we are talking about, I believe, is $155 billion on 59 programs. That is the total pie, and I think that the administration's proposal is to take that total pie and to re-divide the funding so as to be the most effective. And some of the most effective programs that I think we all agree are in the AFDC and the Medicaid areas.

Mr. HELMS. Could I respond? The working group put language into the legislation which will be submitted today or tomorrow, which says explicitly that the purpose of these demonstrations must be to help the low income population. We are trying to give States flexibility, but at the same time make sure that the purpose of these demonstrations is to address the needs of those populations previously met by the original programs. A Governor can come forward with his own ideas for modifying government welfare programs, but he must show that the low-income population will benefit. We have language in the bill that says you have really got to concentrate on those that are most poor.

Mr. FORD. Yes, but in your GROW program, you talk about $108 million, only $8 million that you would place into the program. Now, the $100 million you indicate somewhere in your proposal that in 2 or 3 years that you would pick the $100 million up, so it will only cost the Fed about $8 million.

You know, your GROW program is very attractive, but it is difficult to embrace it because of the dollars that we are talking about. The Governors' Association and their GROW program, they are talking about $500 million to $1 billion. You have embraced it, but you have not embraced the financial aspect of it.

Now, what if the JTPA and existing education resources are insufficient to serve the AFDC population? There has been a lot of talk about the JTPA being able to serve the welfare population, and I would like to note that JTPA now serves only a fraction of the potential eligible population; and it has not been very successful with the hard core to employ.

We all know that there is a hard core group that we are going to have to focus on with the AFDC population. And I am not certain under the current regulations of the JTPA that we can focus the Job Training Partnership Act to take care of the hard core, the core group of AFDC recipients.

Mr. HELMS. As I understand it, there is some new money in the Labor Department budget, about $800 million, I think, that——

Mr. FORD. Well, that is in the training program, $800 million; $750 million is coming from the youth summer program, and they are proposing only 50 million new additional dollars in the Labor Department. If we take work, education and training at their $800 million revenue side of it, 750 million of that would come from the youth summer training program, and only 50 million additional dollars; and in your GROW program you only have about $8 million additional.

Mr. HELMS. Well, let me go back to the GROW estimates. I think it is a matter of estimates on savings and so on. We do think that the evidence on work requirements leads us to be very optimistic in terms of what can be achieved there. And we do think that the

States would have a lot of potential for actually breaking the cycle of dependence.

We know it is going to take several years, and that is why we have got some upfront costs. But eventually people are going to be able to get jobs and get off of welfare. States end up saving and so does the Federal Government.

Mr. FORD. Mr. Chairman, I know the time has expired now, but one question for the record I would like for Dr. Bowen to respond back to the committee.

You know, GROW would also require mothers with 6-month-old children to participate in the program. I am concerned about whether or not you think this is wise. Are you prepared to pay the high costs of infant child care for these babies? And would the mother's participation be part-time or full-time under your recommendations?

Secretary BOWEN. Thank you. We will respond.

[The following was subsequently received:]

## INFANT AND CHILD CARE

### Arrangements

Census surveys show that employed mothers with young children rely more on informal child care -- care by family, friends and neighbors -- than on more formal group arrangements.

According to the 1984-85 Survey of Income and Program Participation (SIPP), the primary care arrangement for children under age 3 with employed mothers is care by a relative (U.S. Bureau of the Census, May 1987). According to SIPP data, among infants and toddlers, care by relatives accounts for 54.4 percent of the child care arrangements for children under age 1 and 50.2 percent of the child care for children 1 and 2 year old with employed mothers.

About 32 percent of infants and toddlers under age 3 are cared for in their own home or in another home by a nonrelative. A relatively small percentage of child care provided to preschool children of employed mothers is provided through formal group child care arrangements (14.1 percent of children under 1 and 17.2 percent of children 1 and 2 years old).

Among single working mothers, one finds a significant difference in arrangements depending on whether the mother is employed full-time or part-time. As the table below shows, single mothers employed part time rely more extensively on child care by relatives than single mothers employed full time. (More detailed data by age are not available.)

Child Care Arrangements of Employed Mothers with Children Under Five Years

| | Total | Relative | Nonrelative in Child's or Another's Home | Group Care |
|---|---|---|---|---|
| Single Mothers Employed Full-Time | 100% | 36 | 32 | 32 |
| Single Mothers Employed Part-Time | 100% | 63 | 19 | 18 |

Source: SIPP, 1984-85

More than a third of mothers working full-time in managerial and other white collar jobs use formal group care for children under 5 while only about 15 percent of mothers working full-time in service and blue collar occupations use such care.

Costs

The data also show that much of the child care provided to preschool children of mothers who work is provided without cash payments or, when payments are made, at modest amounts. These findings are consistent with the heavy reliance by mothers of preschool age children on informal family care and the low rates of use of expensive formal group care.

The 1984-85 SIPP data show that 59 percent of employed mother families with children under 1, 48 percent with children 1 and 2 years old, and 43 percent with children 3 and 4 years old do not pay for child care.[1] Since so many families do not pay anything for child care, the average annual child care expenditures -- by families of all income levels -- are only $855 for children under 1, $1000 for children 1 and 2 years old and $1100 for children 3 and 4 years old.

The amounts paid seem to differ more significantly depending upon whether the mother is working full time or part time, than upon the age of the youngest child. The average annual expenditure for employed mothers working part-time with children under 5 is about $400.

Administration Estimates

The Administration child care estimates are based on estimated expenditures by lower-income working mothers of preschool-age children. (Since there was little difference depending on whether the children were infants or preschoolers, we did not develop separate estimates for infants.) As noted above, the surveys show that employed mothers with young children rely on informal child care more than on formal day care center arrangements. Our pricing assumes that when it is available, mothers will continue to favor informal and family care for their young children.

Overall, we have assumed that there will be substantial increased expenditures for child care as a result of involving families with young children in mandatory work, training and education programs. The higher demands for preschool and infant child care are reflected in our Federal child care cost estimates.

| | (millions) | | | | |
|---|---|---|---|---|---|
| | FY88 | FY89 | FY90 | FY91 | FY92 |
| AFDC | $40 | $101 | $201 | $296 | $398 |

These costs represent one half of estimated total cost, with states providing a like amount. The child care funding is based on a 50/50 Federal/state match and is open-ended, i.e. the Federal contribution is equal to state spending regardless of amount.

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[1]Nonpayers include families not paying cash, and families where only immediate family members cared for the child.

Mr. PICKLE. You would respond to that, Mr. Ford, in committee, Mr. Commissioner. Thank you.

Now, the Chair recognizes Mr. Brown.

Mr. BROWN. Thank you, Mr. Chairman.

Dr. Bowen, they tell me that former Colorado Governor Dick Lamm has written an article that appeared in the New York Times a couple days ago about catastrophic illness and heroic measures.

Have you had a chance to read that article?

Secretary BOWEN. I have not had the opportunity to do anything other than the headlines if he had talked about it.

Mr. BROWN. I do not often find myself as urging people to read Governor Lamm's material, you understand. But if I understand correctly, you raised some interesting issues about heroic measures in the medical field.

Let me ask you: Is it your impression that Medicare does pay for heroic measures to be taken on the patients who are terminally ill?

Secretary BOWEN. Yes, Medicare does pay for those procedures, ordered by a physician I think I mentioned at the last hearing that about 30 percent of all of the costs of Medicare are spent on individuals in the last year of their lives; a little over 20 percent is spent in the last 6 months; and 10 or 11 percent is spent in the last 40 days. It is that 40-day period when a great deal of the heroic types of measures are done—and, I would have to admit—sometimes when the chance of success is not very great. But still, if you put yourself in the family or the individual's situation, with a dear one threatening to pass on, I think that we would all say "let us do what we can."

However, it is my judgment that the individual himself or herself should have some opportunity to say whether that should be done or not, and that is why I like the idea of a living will whereby individuals can say ahead of time whether they want these various things done.

Mr. BROWN. Can you give us an estimate of what portion of those cases involve someone who is terminally ill who cannot recover? Is it half, a third, a fourth?

Secretary BOWEN. It would be a matter of judgment, but it would be a fairly high percent, I am certain.

Mr. BROWN. Would there be a significant savings to Medicare if you did not permit compensation for unusual heroic measures for people who are terminally ill?

Secretary BOWEN. I do not know how you would define that. What heroic measures one might do for, we will say, someone who is badly injured in an automobile accident and previously healthy, might have a greater chance of success than with someone who had had a slowly growing malignancy and was on his last hope of life.

I do not know how you define some of those things.

Mr. BROWN. Well, is there a way to get a handle on it? Do you have statistics? I mean, is there a breakout of people who are over 80 years old who have a terminal illness and who the institutions perform expensive and exotic treatments on? Do we keep statistics in that area?

Secretary BOWEN. We have statistics on hospice use, but again, the hospice use I think is not necessarily performing heroic acts.

Hospice use is more for those who know that they are going to pass on and are there to get good nursing care and otherwise all the good, kind care that can be had.

Mr. BROWN. Doctor, would it be possible for the department to provide the committee with an analysis in this area of the kind of things that might come under the term of "heroic measures," and the potential kind of descriptions you could come up with with regard to someone terminally ill? I mean, I recognize those are very difficult areas, but is there anything you could provide us in the way of information in those areas that might be helpful?

Secretary BOWEN. All I can say, Congressman, is that we will try, but right now I would say it would be very difficult to come up with answers that different people would agree on because we have to assume so many things.

Mr. BROWN. Anything you could provide would be much appreciated. I think you can understand the concerns we have here. Obviously, what we may be looking at is not the question of denying someone health care; it may be a question of making sure that the limited resources we have are spent in the best way, channeled in the directions most productive.

Secretary BOWEN. Yes, I understand.

Mr. BROWN. I am sure everybody would take humanitarian concerns——

Secretary BOWEN. I do not want to put it on a dollars and cents basis either. But, to do so if 10 percent were ascribed to heroic measures and our total spending on Medicare would be $73 billion, it is easy to figure out the savings. But I do not think you can really measure the cost with the amount of good that still can be done with some of these heroic measures.

Mr. BROWN. I appreciate that, but I think if you can give us some guidance with regard to what might be termed heroic measures and some guidance as to what might be considered a viable definition of someone terminally ill, that would be very helpful.

Secretary BOWEN. We will try.

Mr. BURKE. Congressman, that would require, I would think, in order to measure you would have to have some agreement. You would need some sort of a consensus panel on what——

Mr. BROWN. I am sorry. I am not being clear. I am not asking for you to come up with a final determination. I am asking for some help on it, not a final one that everybody agrees on. I am simply asking for you to supply some background information as possible alternatives.

Mr. BURKE. Just so long as you realize other people could very easily shoot at whatever number we come up with.

Mr. BROWN. To find that people occasionally disagree with me would, of course, be a new experience, as I am sure it would be for you. But I very much appreciate anything you can give us in the way that might inform us or suggest alternatives.

[The following was subsequently received:]

RESPONSES OF SECRETARY BOWEN TO QUESTIONS POSED BY CONGRESSMAN BROWN

*Question.* Which so-called "heroic" medical treatments are now funded under Medicare?

Answer. We cover any treatment which the attending physician considers medically necessary in the individual case and which is not considered an experimental medical procedure.

The definition of "heroic" treatment would vary from physician to physician and would depend on the circumstances of the individual case. The Department has always refrained from intruding upon the indiviual physician's medical discretion concerning what constitutes reasonable and necessary treatment. Under Medicare law, only another physician can pass judgment on the work of a particular doctor. This principle forms the basis for the Peer Review Organizaitons (PROs) which have the responsiblity for assuring that the care provided to Medicare beneficiaries is medically necessary and appropriate.

Within the realm of covered procedures and treatments, we know that practice styles vary from one locality and from one specialty to another. What one physician might call "heroic" another might consider routine. In passing judgment on the appropriateness of care administered, the PROs constitute the best means of identifying abuses of either under-care or over-care within the system while allowing flexibility within commonly accepted limits of what constitutes appropriate medical practice in the given locality.

The Public Health Service also provides us with their considerations and recommendations as to whether a treatment or procedure is considered standard experimental by the medical community.

*Question.* What standards are used by your department in classifying a person as being "terminally ill"?

Answer. Generally, medical prognoses are strictly within the purview of the individual's physician and have little impact on covered services furnished under most Federally supported programs. However, under Medicare, the hospice program specifically addresses the needs of the "terminally ill." As defined in the law, for this program, an individuals is considered to be "terminally ill" if the medical prognosis projects a life expectancy of 6 months or less. Eligibility for the hospice program depends on the judgment of the attending physician in the individual case.

*Question.* Do you have any cost figures available on the treatment of the terminally ill?

Answer. A study done in 1984 by HCFA's Office of Research, using 1978 data, revealed that 28 percent of Medicare costs for the aged (under 65 ESRD and disabled beneficiaries excluded) were spent for care given during the last 12 months of life; 21 percent went for the last 6 months; and 8 percent for the last month.

Total Medicare spending for the aged in 1984 was $55.374 billion. Applying the results of the HCFA study to these more recent cost data would mean that roughly $15.504 billion was spent for the last year of life, $11.629 billion for the last 6 months; and $4.430 billion for the last month of life.

Secretary BOWEN. Thank you.

Mr. BROWN. I yield back, Mr. Chairman.

Mr. RANGEL [presiding]. Mr. Levin.

Mr. LEVIN. Thank you, Mr. Chairman.

Dr. Bowen, let me just quickly review the GROW program. We deeply appreciate your commitment, so my questions and comments do not reflect for a second on that.

You know what it adds up to as I see it? We now have a WIN demo program of $110 million. You are going to abolish that, and you are going to replace it with a GROW program of $110 million, but you attribute $102 in savings the first fiscal year with a net of $8 million.

So in terms of training AFDC recipients, instead of $110, you really come up with a net of $8 million. And I just do not find it expressive of a commitment or believable.

Now, you then refer to $800 million in a youth program, but that is not for adults; it is youth. And of the $800, $750 million is already budgeted for summer youth programs.

And then you referred to $980 million for training in the Labor Department, but that is not earmarked for AFDC recipients; it is

part of a trade competitiveness program that is focused on dislocated workers.

Mr. HELMS. Let me say, Mr. Congressman, that these were estimates. One of the differences between GROW and WIN is that WIN was a fixed appropriation, while GROW funding is open-ended. The Federal matching rate for WIN was very high, but it was a fixed appropriation.

Our GROW numbers are an estimate of net costs.

Mr. LEVIN. What we would spend. You estimate we would spend $110 million, and that we will save $102 the first year. So simply to say it is open-ended, when you add it all up, is wrong——

Mr. HELMS. Then we are obligated to pay the 50 percent matching rate.

Mr. LEVIN. That is not training. That is not for training and retraining. It is for support services.

Mr. HELMS. That is right.

Mr. LEVIN. So in terms of training and retraining, you end up with less money.

Mr. HELMS. But at the same time, we think we have given the States a lot more flexibility to develop AFDC work programs as well as training programs to meet our participation requirements.

Mr. LEVIN. All right. I am glad that is your fall-back position, and now I want to read—by the way, I would like the cost estimates of the $102 million. I would like the breakout. The GAO says this. "Because long term AFDC users consume the most benefits, working with these individuals who tend to have greatest barriers to employment could help save money in the long run. However, focusing on them costs more because of the more intensive services required, and it takes longer to produce results."

Now, I think there are cost savings in well-tailored, constructive, creative welfare

Mr. HELMS. We would be glad to supply what we can. We have not really had a chance to sit down with the CBO staff and go over that.

Mr. LEVIN. I would like to see your working papers. I assume there is more than a back of an envelope. I would like you to send me your work product.

Now, your fall-back position is, well, the Governors will be creative. And, Dr. Bowen, you say, "As a former Governor, let me tell you it sounds pretty good to governors to hear the President say they will be given the flexibility to try to make welfare work better. Many Governors have been trying to do that within the flexibility currently allowed to them, but we can and should do more to give them a chance to succeed."

They have come here, and all but one have said to you and the rest of the administration, "provide us a program. We will participate. We want flexibility, but vote through a program that provides training and retraining moneys targets for people on AFDC with a cost of anywhere from $500 million to a billion, and if Medicaid is included, more than that."

Now, I do not see how, on the one hand, you can say do more to give them a chance to succeed, laud the governors, and then totally repudiate their message in terms of our acting on a welfare reform package, especially welfare.

You pat them on the back and then you shove them out of town empty-handed. Is that not what you are doing?

Secretary BOWEN. No, I do not think so. I think they left with a lot more hope and satisfaction than when they came.

Mr. LEVIN. What did they propose, though? They proposed a welfare/work program with matching Federal/State resources, and to that you are saying "Nyet," right?

Mr. HELMS. Let me add something. I did——

Mr. LEVIN. No, but, Dr. Bowen, you are saying no—I do not mean personally—but in your testimony you are saying zero to them in terms of money for training and retraining.

Secretary BOWEN. Yes, but we have also stated that we agree with essentially all of their requests and all of their plan with the exception of the national standard being established and the method by which it should be funded.

Mr. LEVIN. No, no. Let me just break in. You are not only saying no to that, but you are saying no to their proposal for $500 million plus in matching funds for training and retraining. There is no money in here for that.

Secretary BOWEN. That is a Labor Department funding.

Mr. RANGEL. Mr. Moody.

Mr. MOODY. Thank you very much, Mr. Chairman.

Let me add my voice of praise to the Secretary and his people for what they are doing.

Mr. Secretary, a couple short questions, and then a slightly longer one if we have time.

Do you know where the data is on state and local employees coverage or noncoverage under Medicare for Wisconsin? I have been asking my State, and there is no good place I can get it community by community. It is not kept in a central place in Wisconsin.

Does your Department have a good data base of which State and local employees are and are not covered? I was surprised to find out there was no ready way to get it in my state. If so, could someone give us that location?

Secretary BOWEN. We will supply what we have.

Mr. MOODY. Maybe after the hearing somebody in the staff could just tell me where to go. Thank you.

The next question is on your savings. According to the CBO calculations here, you propose to save what CBO estimates is about $2 billion on delayed payments. Actually it is $1.3 billion on delay and $0.7 billion on eliminating PIP.

By delaying outlays, which those two do, we do not really save any money. Do we not just push the outlays into a different fiscal year? This is not a savings; this is just a shove. Am I correct?

Mr. BURKE. There are some interest costs involved there.

Mr. MOODY. It is some interest costs, but you are asking the institutions to pay interest costs that they would otherwise not have to pay. So that is a form of a tax, if you will; it is a disguised tax. But the bulk of the money, the $2 billion as shown on the savings, is just a shove, not a save. Is that right?

Mr. BURKE. Well, you mentioned PIP. The rationale for eliminating periodic interim payments was that that program was put in place when we reimbursed hospitals on a retrospective basis, and they frequently would not know what their final tally was and

what was due them until perhaps 2 years after their books had closed and they had been audited. So we paid them on an interim basis.

Mr. BURKE. We no longer have cost reimbursement for hospitals so that it no longer makes sense to make payments up front.

Mr. MOODY. I understand, but you do not expect to pay—you are not going to put it up front. You are going to push it back, now. Is that right? Except for interest charges, you do not expect to save money on that, do you?

Mr. BURKE. We are eliminating the fifth payment which is giving the money up front.

Mr. MOODY. But you are not saving the money, you have just timed the spending a little differently.

Mr. BURKE. Right. A one shot saving.

Mr. MOODY. It is a one shot saving for 1988. It is not a one shot saving if you look at a multiyear framework.

Mr. BURKE. It helps to meet the bottom line.

Mr. MOODY. But the bottom line for a year will make the bottom line tougher in 1989. Maybe we should eliminate PIP for other reasons, but it bothers me that that, plus the slow reimbursement, which is about twice your savings in PIP, is really savings in quotes here.

Mr. BURKE. It is a cash flow problem, and I think that they are more able to control their cash flow now, and buy more timely submission of their claims.

Mr. MOODY. Delayed reimbursements, though; you may hear from providers and hospitals that they may feel that it is a real hardship for them. You transfer cash flow problem from the Government to them, in a sense.

Mr. BURKE. I do not think the beneficiaries are really impacted on this payment cycle; the big fuss and furor we have heard about has been from the providers. Many of the providers are now in on electronic funds transfer, and are getting their money in about 20 days or fewer. Significantly fewer, the large——

Mr. MOODY. Okay, who is going to be here with the delay, then?

Mr. BURKE. Part of the delay, which is the concern of Congress, can be attributed to the beneficiary. For example, they must submit bills to Medicare for physician services, and be paid for this. But, the vast majority of the money are being paid well under the time frame of 30 days.

Mr. MOODY. I guess I am asking, are these management improvements, or is this a way of getting the bottom line down?

Mr. BURKE. I think there is an honest disagreement between Congress and the Department on this. We look at 30 days as cash. Congress does not. Congress would like us to go down to 26 and then 24 and so on, but for the vast amount of our money we are way out in front of that.

Mr. MOODY. Okay, my next question regards the 5-day differential between your estimation and CBO's estimation of your total spending. They take the President's budget and they reestimate it using CBO techniques, and they come up with $78 billion. The Department has $73 billion in your spending total. So can you give me some explanation why you think CBO is right or wrong in this case? That is a big hunk of change, and we are trying to meet a

$108 billion Gramm-Rudman target, so a $5 billion differential is a big hunk of money. It is about 6 or 7 percent of your budget, so that is a big discrepancy which bears looking in on.

Mr. BURKE. I will explain it as far as I can. I cannot take you all the way because I do not honestly know it. Inherent in the CBO estimates is this baseline problem we have to deal with every year. We have, in our budget, a set of assumptions at times at variance with theirs. We have program savings which they do not recognize. If some of our legislative proposals do not pass, then we are going to come up with a different bottom line.

Mr. MOODY. Okay, so your baseline assumes current legal——

Mr. BURKE. The baseline is current law. There are some variations and assumptions, such as in time frames, but the basic intent is to estimate what the program will cost if it continues out. And we have assumed a slower program growth than CBO. That accounts for the——

Mr. MOODY. My other question, which I will not have time for because the red light is on, regards the various issues regarding the DRG. The rural versus nonrural differential seems to be too wide, from what I am hearing, because of the mass purchase orders that even rural hospitals now have. Their costs are not that much lower, really. Professional services are not that different. The nonprofessional services are very different, so that differential probably needs an overhauling. Maybe I can write you a letter about that.

Mr. BURKE. We have a report coming on that we would be happy to share with you.

Mr. MOODY. And then there is a center city issue which I will get to you. Thank you.

Mr. ANDREWS. Thank you, Mr. Chairman. Dr. Bowen, I just want to add my accolades to the other members of the committee. I think the leadership you have shown has just been tremendous during your tenure. Just to follow up on a couple of questions briefly. To follow up Congressman Levin's questions to you about the program, I am curious about what assurances you might give us, and what are your thoughts about how to insure that the States achieve a consistent quality and consistent implementation of the program.

Mr. HELMS. A consistent quality, and what?

Mr. ANDREWS. Implementation of your program. How do you monitor the states. What is the machinery to insure you that the states are carrying out your program.

Mr. HELMS. We have deadlines that they must meet. The program phases in over 5 years. Within the first year they must reach 20-percent participation. The percentage increases 10 percentage points a year, until participation is up to 60 percent. There would be some penalties involved on not meeting them.

Mr. ANDREWS. What are the penalties? And is that kind of penalty effective. Has it proved effective in the past?

Mr. HELMS. They are rather modest. If the State fails to achieve the overall required participation rate, their annual AFDC reimbursement will be reduced by 0.1 percent for each 1 percent part of the required participation rate that is not achieved. There is a separate penalty for participation rates of teenagers, and that is 0.025

percent. We think those are modest, but we think they would give the State some incentive to keep up with the participation rates.

Mr. ANDREWS. Do you have any statistical data to show whether or not that kind of punishment works? I mean there is really not anything to support that. I guess the question is, is it going to work.

Mr. HELMS. We think it will.

Let me get back to a point that has been brought up here a couple of times in terms of questions about child care and whether 6 months is a reasonable age. We were very sensitive about that issue. You have to look at the other side, though, and consider all the research about who gets trapped into welfare and stays on for a long time. We do know that that tends to be young teenage mothers without a high school education who get in that situation and are in a welfare trap. They cannot get a job, they do not have the time to get away from the kids and so on. So, we have tried to make sure that we get those people in when their kids are relatively young. We try to make sure that they have a part-time work requirement to do that. And even the participation rates—they are very modest, we think, because you are going to have a much larger pool of people to participate when you lower the requirement from the 6-year-old kid down to 6 months.

You are adding over half a million people to the base used in calculating overall participation rates. And so, we think they are modest and they still leave the State with some 40 percent of the people that they would not have to have participate if they meet the 60 percent participation rate.

This enables States to deal with the hardship cases, and situations where it is just not reasonable to expect a woman to go out and work.

Mr. BOWEN. I might mention that I think the penalty will work, and as a former Governor, I know that any penalty that was put on our State soon became an embarrassment on headlines on the front page of the paper, and Governors never like to have that type of criticism.

Mr. ANDREWS. But Dr. Bowen, that is all this is. It is surely not going to hurt them financially.

Mr. BOWEN. It is a stimulus to the Governor to get his department to function better.

Mr. ANDREWS. But we also looked at the question that you really had to have this as mandatory. If you really put it in voluntarily, we have evidence that some of the volunteer programs seem to take the highly motivated part of this population and get them—they are probably the people who, like a lot of AFDC people, come on and then get a job and go off, but we are trying to get the States an incentive to get at that hardcore of people who usually do not get off of AFDC. Thank you. I yield back the balance of my time.

Mr. RANGEL. Doctor, OMB has indicated that the 40 percent of the savings in the president's budget, as relates to Medicare cost, comes from shifting costs forward to the next fiscal year. And they go on to talk about in chapter 5, page 116, that CBO estimated that $2 billion in outlays will be delayed from 1988 until 1989. But the part of this concept, which I am concerned about most, and you referred to in part, is that part of the periodic interim payments. It is

my understanding that if this program is eliminated, that the programs that actually serve the cause of the poor, those with the least amount of ability to take care of themselves, are going to be seriously crippled because of the cash flow problem.

And they have so indicated. And, of course, in my city, referring to the municipal hospital system, not just one hospital but the entire system, did I understand you to say that the systems' accounting programs have so improved that you do not see that this is really going to hurt them? I am not talking about an inconvenience, I am talking about causing possible closures of these hospitals because of the margin in which they operate.

Mr. BOWEN. I do not know, if one can say that it would not hurt any of them, but it would affect only a small subset of the disproportionate share hospitals. The approximately 300 large urban hospitals that are currently receiving the adjustment of the 5.1 percent or more to their PPS payments have no question that eliminating the PIP will result in some temporary disruption of the cash flow. I do not think anybody denies that.

Mr. RANGEL. Cannot you give any assurances that when you are dealing with the poorest hospitals, the poorest and sickest people, that this accounting gimmick—that you will give some insurance to make certain that these hospitals are not going to be crippled financially. You are dealing with the least powerful people in the country. They are poor, they are sick, they are in the hospital and all you are doing is talking about delaying payments to them. It is not really a savings of any kind, and yet to the hospital it could make all the difference in the world. Can you give assurances that you will look into it, study the cases, and if indeed the data that is provided by CBO and by these public hospitals, or those that serve the disadvantaged communities and have a disproportionate share of the poor, that we will try to work out something?

Secretary BOWEN. We shall look into it, but actually these payments are payments in advance. And we think that they can work out their cash flow problems a little bit better than they have been by timely submission of claims.

Mr. BURKE. I think, Congressman, too, that the large inner-city urban hospitals are having financial problems. Nobody argues that point. They have disproportionately large amounts of bad debts and uncompensated care. I do not think maintaining the PIP mechanism should be used as a surrogate for addressing this other issue.

Mr. RANGEL. I agree with you, Mr. Burke. But it does not help when you add on to the more serious problems that they have, and I am just asking that my Federal Government—the problem why poor people get sicker than other people certainly has nothing to do with payment. But, your changing the accounting system, and there is no question in your mind that it is going to affect the ability to deliver services to them. I am asking you to take another look at it. I am not saying that PIP is going to eliminate the ills that they have.

Let me ask another question. I assume, Doctor, that you are directly involved with this administration's war on drugs and have had input of how this war should be conducted.

Secretary BOWEN. Yes, we have been involved.

Mr. RANGEL. Is it a task force that you are member of that advises somebody or the President.

Secretary BOWEN. Yes, recently I have been appointed as the Vice Chairman of the Drug Policy Board.

Mr. RANGEL. Then, do you see the stepped up program, both the legislative program and the White House program, and just "saying no," and increased law enforcement as causing more people to seek treatment? Is that the goal of the administration to get people off of drugs and into rehab?

Secretary BOWEN. The goal, of course, is to get people off and to treat those who are on. And in our area, in contrast to Justice's area, we are to make every effort to reduce the demand for drugs. The Justice Department deals more with the supply. We are making every effort to decrease the demand through information and educational campaigns, and then of course, assist the States in their treatment programs.

Mr. RANGEL. Well, has it been your experience, as it is mine, that when you step up the law enforcement, that you do find sharp increases in the number of people that seek treatment?

Secretary BOWEN. Yes, I think that you are right.

Mr. RANGEL. There is a relationship.

Secretary BOWEN. Yes.

Mr. RANGEL. And also, because of the increase in the production and flow of drugs into the country, this would cause a sharp increase in the need for treatment?

Secretary BOWEN. Right.

Mr. RANGEL. So, no matter what signals you use, it appears as though, without a program, that there would be more people seeking treatment, and with the program there should be dramatically more people seeking help. The reason I ask all these preliminary questions is that it appears as though, in the President's budget, he is not seeking any additional funds to assist in this treatment, and I was wondered how that made any sense at all, that we would cause people to seek treatment, and then not facilitate that treatment.

Secretary BOWEN. I think there has been some misunderstanding concerning this. As I understand it, the program was to be implemented over a 2-year period, 1987 and 1988. And we had $252 million new dollars that were applied. That is over and beyond what ADHAMA and other areas of our Department have for the drug programs. And of that $252 million, $75 million of it was to be put into research and prevention programs, and the other $177 million was to be given back to the States to assist them in the development of their treatment plans.

So there was considerable one-time use for this money, which was to be spent over the 2-year period; the rest of the funding was allocated to be spent over the 2-year period of time, and I think that that is going quite well. Actually, distribution of 45 percent of it was to be based on population—I think most all the states have received their funding already for that—and 55 percent was based on need. And we have established a formula for the need, and most of the States are in the process of making application now, and or are receiving their funds.

But it takes them time to set up their various programs and we think making the allocations over the 2-year period will satisfy that. It is in the 1989 program when need to relook at extra funding.

Mr. RANGEL. Well, it seems from what everyone who has reviewed the budget, including CBO, even though I agree with you that there is some misunderstanding that for 1988 the funds are frozen. Are you saying that there will be more moneys available than those that are presently allocated for the States for 1988 to deal with treatment.

Secretary BOWEN. $252 million more that was allocated. And that is what we are in the process of doing now. And again, that is over and above the several hundred million that ADAMHA has to allocate.

Mr. RANGEL. With all of the national programs indicating that people who need help should seek it, and all of the free numbers to telephone, and all of the problems that the States are having to meet the demand in terms of treatment and rehabilitation, is there any Federal program at all that the States can look to to get any assistance as to nationally what we should be doing to assist people who abuse drugs?

Secretary BOWEN. Our national experts on this are in the Alcohol and Drug Abuse and Mental Health Administration, and its National Institute on Drug Abuse—NIDA. We consider them top experts, and I think they are doing an excellent job of supplying information to whomever needs it for these various programs.

Mr. RANGEL. Well, I do not think they have any outreach program. There is no question that they are the experts, but that expertise does not get down to the local and State level, and even with the Education Department before we had this bill, they had all the expertise in Washington, but they only had $3 million in terms of sharing that expertise as relates to drugs with local communities.

In other words, the President has made it a national problem that we ought to deal with in a national way, and when you talk about treatment and rehabilitation, I do not see where there is a national program to deal with it. What we are saying is, that while it is a national problem, that the States should handle it in their own way, and that we do not have a model or anything to suggest to them.

Secretary BOWEN. Congressman, I think that our National Institute on Drug Abuse and ADAMHA have been very visible nationwide. And, we are also getting millions of dollars through the private sector, through small expenditures from our Department to assist in that. For example, you will see on television frequently some of the star athletes of the country coming out on behalf of saying no to drugs, and there is a campaign "Cocaine: the big lie," and so forth.

Mr. RANGEL. I guess what I am talking about, doctor, they do an excellent job of getting aware of the dangers of drugs, but I am talking about when it comes to the actual treatment, the actual rehabilitation, where many of the treatment centers have either closed or have been not able to take care of their problem. We attempted to deal with them in part by increasing the amounts of

Federal dollars that is available to the States, both in education, treatment, and rehab. But my question is, that I have not seen on television, nor should that be the place to see it, where we have a national modality in terms of expertise that is going to the local and State, as to how nationally we should be dealing with this. In other words, I get the impression that nationally we tell the Nation that we have a problem, but then we suggest to them to resolve it locally. And the expertise, as you say, may be in NIDA, but I do not see where we have any national recommendations except get local assistance.

I watch these things on television, and they flash numbers. Those are not Federal numbers. Those are numbers to go to get local help. So, you alert people that it is a very serious problem, but if someone would ask me, as a Federal legislator, where do they go for Federal information, do I suggest that they go to NIDA?

Secretary BOWEN. They can go to NIDA. They can come directly to me if they want to.

Mr. RANGEL. You mean, that if I have an addict that is seeking treatment, I should send him to you?

Secretary BOWEN. We will find a way that they can obtain treatment, and tell them where to get it. State governments are very effective in their treatment methods. Obviously, when you have a great emphasis on reduction of supplies, you stated there are going to be more individuals who want and demand treatment, and we know that there are some waiting lines in some of these areas. But we are trying to fill that need as best we can.

Mr. RANGEL. How?

Secretary BOWEN. Through our assistance with the NIDA and ADAMHA, and we have block grant funds that are going out to the States. And the States can have a lot of flexibility on where to put this.

Mr. RANGEL. Chairman Ford.

Mr. FORD. Thank you, Mr. Chairman. Mr. Chairman I know that it is almost 12 and the Secretary has been so gracious and so kind to remain here and respond to all of the question by the members. There are two other questions to which I would like you to respond, maybe at a later date in writing to me, if you do not mind.

The program would require school attendance by teenage parents, something which should be encouraged as the chairman of this Welfare Subcommittee. But how do you propose to enforce this requirement. If you would respond to that. What if a special remedial education program needs to be developed for a group of AFDC recipients, and long-term training is needed in this area. JTPA focuses on short-term training. How would that be implemented if we are going to continue to talk about the Job Training Partnership Act being the focal point for job component in this area. If you would respond to those two areas, Mr. Secretary, I would appreciate it.

Secretary BOWEN. We will respond for the record.

Mr. FORD. Thank you.

Mr. JACOBS. Mr. Secretary, I speak for the entire committee in expressing our gratitude again for your time, and I must say, your patience, with perhaps some repetitive questions from time to time. So, with that, I believe the committee will stand adjourned.

[Whereupon at 11:55 a.m., the hearing was adjourned.]
[Submissions for the record follow:]

STATEMENT OF THE AMERICAN CANCER SOCIETY, AMERICAN HEART ASSOCIATION AND THE AMERICAN LUNG ASSOCIATION, AS THE COALITION ON SMOKING OR HEALTH

The American Cancer Society, American Heart Association and American Lung Association, together acting as the Coalition on Smoking OR Health, welcome this opportunity to comment on the President's Fiscal Year 1988 budget/revenue proposals.

As submitted, the Administration's FY 88 budget calls for approximately $22 billion in new revenues. Although one source of revenue, the cigarette excise tax, was not specifically discussed in the official budget transmittal, the Administration has indicated it could support an increase in this revenue source.

For example, earlier this month, Office of Management and Budget Director James Miller stated that a cigarette excise tax increase could be acceptable due to the "negative externalities" of cigarette smoking, i.e., the costs that cigarette smoking impose upon nonsmokers. This view closely corresponds with that voiced by Treasury Assistant Secretary for Tax Policy J. Roger Mentz, who, in 1986 testimony before the Senate Finance Committee, stated that excise tax increases may be justified due to the "external costs associated with the production or consumption of the taxed good." Both views are buttressed by the Council of Economic Advisers' 1988 Economic Report, which documents that past increases in the cigarette excise tax have yielded the beneficial effect of reduced consumption and the resultant effect of reduced smoking-related death and disability rates.

The American Cancer Society, American Heart Association, and American Lung Association commend the Administration for its recognition of the economic costs associated with cigarette smoking. We urge the House Committee on Ways and Means to follow the Administration's lead and enact a sixteen cent increase in the federal cigarette excise tax.

The history of the federal cigarette excise tax extends over slightly more than the last century. The tax was first imposed during the Civil War at a rate of less than one cent per pack. It was increased to ten cents during Reconstruction but fell back to one cent in the late 1800s.

In the post World War II era, the federal cigarette excise tax has been incresed only twice: from seven cents per pack in 1950 to eight cents in 1951, and from eight cents to its current level of 16 cents with the passage of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). It should be noted that the TEFRA increase was scheduled to expire on October 1, 1985. However, the 16 percent cigarette excise tax was made permanent with the enactment of the Consolidated Budget Reconciliation Act of 1985.

Last year, as part of its budget reconciliation package, the Senate Finance Committee reported an eight cent increase in the federal cigarette excise tax, raising the tax from its current level of 16 cents to 24 cents per pack. Unfortunately, this provision was not included in a compromise measure later adopted by the Senate.

Despite recent increases in the federal cigarette excise tax, the tax has failed to keep pace with the rate of inflation. If the 1951 eight cent cigarette excise tax had been indexed for inflation, the federal government would now be collecting 32 cents in tax revenue for every pack of cigarettes sold.

However, because the cigarette excise tax has not kept pace with inflation, tax receipts from this source have declined. Seventy-five years ago the excise tax on tobacco products accounted for approximately 20 percent of the federal government's income. In 1984, following enactment of a 16 cent federal cigarette excise tax, federal receipts from the cigarette excise tax accounted for only about 0.7 percent of federal revenues and slightly more than 0.1 percent of GNP.

While the cigarette excise tax's contribution to federal revenues has steadily declined, costs related to smoking have continued to increase. According to a 1985 Office of Technology Assessment (OTA) report, health care costs of smoking related diseases are estimated at between $11 and $35 billion per year or from three to nine percent of total U.S. health care spending costs. This include $6.9 billion for cancers, $8 billion for circulatory system diseases, and $6.7 billion for respiratory system diseases. Approximately 75 percent of these costs are incurred by individuals under the age of 65.

The federal government alone is estimated to spend between $2.3 and $6.1 billion in treating smoking-related illnesses. Annual smoking-related costs incurred by the federal government include: $1.7 to $5.4 billion by Medicare; $0.3 to $1.1 billion by Medicaid; and $0.2 to $0.6 billion by the Veterans' Administration.

In sum, OTA has concluded that the middle estimate for annual smoking related health care and lost productivity costs is $65 billion or about $2.17 per pack of cigarettes (in 1985 dollars).

A 16 cent increase in the federal cigarette excise tax could help defray some of the smoking-related costs now incurred by our country. But more importantly, an increase would encourage millions of young Americans to forego the tobacco habit. According to Kenneth Warner, Chairman of the School of Public Health, University of Michigan, "an 8- to 16-cent tax increase would encourage from 1 to 2 million young persons and 800,000 to 1.5 million adults to quit smoking or not to start."

Perhaps it is for this very reason that Americans overwhelmingly support an increase in the cigarette excise tax. Indeed, a February 1986 poll conducted for the Los Angeles Times found that when individuals were asked, "Would you favor one of the following revenue hikes or would you rather consider some other way to raise money for the government," 81 percent of all responsdents favored higher taxes on cigarettes and liquor. The next most favored alternative, a national lottery, garnered the support of only 65 percent of all respondents. Among other options 51 percent favored charging user fees; 45 percent favored higher tariffs on imported oil; 36 percent favored higher gasoline taxes; 31 percent favored a national sales tax; 24 percent favored an increase in income taxes; and 10 percent favored charging more for Medicare.

Similar results were obtained in a poll conducted for Time in February 1984 in which 77 percent of responsdents supported an increase in the tax on tobacco as a means of reducing the federal deficit.

The primary concern voiced by those who have opposed an increase in the cigarette excise tax is the impact such action will have on America's poorer citizens who happen to smoke. Yet, because the majority of smokers smoke less than one pack of cigarettes per day (the 1983 Surgeon General's report found that 65 percent of all male smokers and more than 75 percent of all female smokers smoke less than 24 cigarette per day), the impact of a 16 cent increase in the cigarette excise tax on these individuals would be slightly more than $1 per week. This should be compared to the OTA's conclusion that the health care and lost productivity costs attributable to cigarette smoking average $2.17 per pack or more than $15 per week for the majority of smokers.

Recently, Representatives Pete Stark and Andrew Jacobs have introduced legislation, H.R. 260 and H.R. 493 respectively, which would increase the cigarette excise tax by 16 cents. The American Cancer Society, American Heart Association, and American Lung Association support these measures.

We also support legislation introduced by Senator John Chafee, S. 447 which in addition to increasing the federal cigarette excise tax from its current level of 16 cents to 32 cents per pack, would also increase the tax now imposed on chewing tobacco and snuff from its current rate of about 1.5 cents per package to eight cents per package.

Revenue returns to the federal government from an increase in the excise tax on smokeless tobacco will not be as significant as the anticipated returns from an increase in the cigarette excise tax. Nonetheless, the impact such a tax increase could have on use patterns justifies enactment of the Chafee proposal.

The tobacco industry is currently enjoying great success in marketing smokeless tobacco products, primarily moist snuff, to our nation's youth. The 1986 Report of the Advisory Council to the Surgeon General on the Health Consequences of Using Smokeless Tobacco found that 12 million Americans used some form of smokeless tobacco during 1985, including 16 percent of males between 12 and 25 years of age. The Committee found that in several parts of the country as many as 25 to 35 percent of adolescent males indicated current use of tobacco products.

Yet, the dangers associated with smokeless tobacco products are every bit as great as the dangers associated with cigarette smoking. Smokeless tobacco products have been linked to cancer, periodontal bone destruction, tooth abrasion, and gingival recession. The American Cancer Society estimates that ten percent of the 9,500 oral cancer deaths that occur in this country are attributable to smokeless tobacco.

Young children are reported to be most price sensitive of consumers. Although responsiveness to price varies, most agree that, on average, younger persons have less disposable income making their demand for tobacco products, which would result from an increase in the federal excise tax on these products, could therefore be expected to produce reduced consumption of these products among America's youth.

The American Cancer Society, American Heart Association, and American Lung Association believe that a sixteen cent increase in the federal cigarette excise tax as well as an increase in the excise tax on smokeless tobacco products to 8 cents per

pack will yield major long turn health benefits for our nation while producing more than $9 billion in new federal revenues. We urge the House Committee on Ways and Means to enact an increase in the cigarette excise tax and the tax on smokeless tobacco as a major health promotion and deficit reduction measure.

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STATEMENT OF THE EMPLOYEE BENEFIT AND RELATIONS COMMITTEE OF THE COUNCIL OF STATE CHAMBERS OF COMMERCE

Currently, GTLI is added to Block 10 (wages, tips, other compensation) on the employee's Form W-2. Since the employer has until January 31 to issue the W-2, the GTLI can be added to salaries and wages paid during the year after the final salary payment in December and before issuing the W-2. There are no income taxes withheld. FICA is a completely different matter since both employee and employer taxes are due on FICA taxable wages. Since the amount of GTLI may not be known in time for the last paycheck in December, the employer has no paycheck from which to deduct the FICA tax. This situation will also happen in the case of lay-offs, quits, discharges, death and retirements prior to year end, i.e., since the GTLI is determined at year end and there is no paycheck, how is the employer to deduct FICA tax.

Another complexity will arise if GTLI will also be included for purposes of state and federal unemployment compensation taxes. Here, the problem is the difference in definitions between federal and state unemployment compensation taxable wages, further aggravating this situation.

This proposal would create additional problems for employers at year end, and in summation, I feel that the administrative expense will not be worth the additional revenues to the social security trust funds.

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